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# TAX REFORM PROPOSALS—XXVII

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

---

OCTOBER 10, 1985

**(Alternative Tax Reform)**

Printed for the use of the Committee on Finance

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# CONTENTS

## Public Witnesses


| | Page |
|---|---|
| American Enterprise Institute, Dr. John H. Makin, director of fiscal policy | 184 |
| Basic Industries Coalition, John K. Meagher, chairman | 65 |
| Boschwitz, Hon. Rudy, a U.S. Senator from Minnesota | 2 |
| Bradford, Dr. David F., professor of economics and public affairs, and associate dean, Woodrow Wilson School, Princeton University | 168 |
| Cascade Corp., Robert C. Warren, chairman of the board | 96 |
| Chrysler Corp., R.S. Miller, Jr., executive vice president | 60 |
| Free the Eagle Citizens' Lobby, John Houston, legislative director | 145 |
| Houston, John, legislative director, Free the Eagle Citizens' Lobby | 145 |
| Institute for Research on the Economics of Taxation, Michael Schuyler, economist | 10 |
| Kelso, Louis O., partner, Kelso & Co | 107 |
| Mack, James H., public affairs director, National Machine Tool Builders' Association | 77 |
| Makin, Dr. John H., director of fiscal policy studies, American Enterprise Institute | 184 |
| Meagher, John K., vice president for government relations, LTV Corp | 65 |
| Miller, R.S., Jr., executive vice president of finance and administration, Chrysler Corp | 60 |
| National Machine Tool Builders' Association, James H. Mack, public affairs director | 77 |
| Schuyler, Michael, economist, Institute for Research on the Economics of Taxation | 10 |
| Warren, Robert C., chairman of the board, Cascade Corp | 96 |


## Additional Information


| | |
|---|---|
| Committee press release | 1 |
| Articles from the Wall Street Journal and the New York Times | 7-9 |
| Prepared statement of Michael A. Schuyler | 12 |
| Economic Report No. 33 by IRET | 33 |
| Prepared statement of R.S. Miller, Jr. | 62 |
| Prepared statement of John K. Meagher | 67 |
| Prepared statement of James H. Mack | 79 |
| Prepared statement of Robert C. Warren | 99 |
| Prepared statement of Louis O. Kelso | 109, 160 |
| Prepared statement of John Charles Houston | 147 |
| Prepared statement of Dr. David F. Bradford | 171 |
| Prepared statement of John H. Makin and Norman Ornstein | 186 |


## Communications


| | |
|---|---|
| Hopkins, Fortescue W | 205 |
| Middle Income Lobby | 223 |
| Association of Flight Attendants | 235 |
| Boner, Hon. Bill, a U.S. Representative from Tennessee | 250 |
| National Easter Seal Society | 255 |
| Eastern Paralyzed Veterans Association | 258 |
| Paralyzed Veterans of America | 263 |
| Morgan, William T.H., Jr. | 282 |

# TAX REFORM PROPOSALS—XXVII

THURSDAY, OCTOBER 10, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Roth, Danforth, Symms, Grassley, Long, and Baucus.

[The press release announcing the hearing follows:]

[Press Release No. 85-076, Monday, September 23, 1985]

MINIMUM TAX, ALTERNATIVE TAX PROPOSALS DUE FINANCE PANEL HEARINGS

Minimum tax and alternative tax reform proposals will be examined by the Senate Committee on Finance at hearings scheduled October 9 and October 10, Chairman Bob Packwood (R-Oregon) announced today.

The hearings are components of the continuing series of hearings in the Committee on Finance on specific aspects of President Reagan's tax reform proposals, Senator Packwood said.

The minimum tax issue will be the topic of a hearing on Wednesday, October 9, 1985, while alternative tax reform plans will be reviewed at the Committee's Thursday, October 10, 1985, hearing.

Both hearings are scheduled to begin at 9:30 a.m., in Room SD-215 of the Dirksen Senate Office Building in Washington.

Senator Packwood will preside at both hearings.

Guests invited by the Committee on Finance will testify at the two hearings.

The CHAIRMAN. The committee will come to order, please. This is the last scheduled hearing on the tax reform bill, our 28th hearing, all of which have lasted at least 2 hours, some 3, some 4, some longer. I think probably I have only missed 5 or 6 total hours throughout all of the hearings. Frankly, I have found them very, very worthwhile. On occasion, I have wondered if there isn't a more efficient way to learn the information, but there has never been a day during the hearings that I didn't learn something I didn't know before. And finally, when you consider the hearings together, over the days or months that the hearings go by, you get a pretty good mosaic of what American industry and individuals are thinking about taxes and a pretty good cross section of the best ideas that exist in this country. Needless to say, the staff, which prepares one of these books every day for me on the hearings—there is a big cartoon on here, "This is your last tax reform hearing,"—are probably happier than most of you who have had to sit through many of these. Today, I find that, as far as I am concerned, the hearing will be as interesting as any we have had. We have a good many different tax ideas, imaginative ideas, some of

them new ideas. I hope I can sit through the entire hearing this morning. As you are well aware, the debt ceiling bill is on the floor, which is under the jurisdiction of this committee; and there are still anywhere from 8 to 15 amendments to be considered, a number of them with votes today. So, I may have to run off at some stage and go to the floor to help in the management of that bill. I hope not. Fortunately, I was able to read all of the witnesses' statements eariler this morining; but I would like to stay through the hearing if I can. Senator Roth, do you have an opening statement?

Senator ROTH. Mr. Chairman, I appreciate these hearings being held today. As you know, one of the things we are going to talk about is the business transfer tax, and an idea whose time has come, at least in my judgment. I want to express my appreciation to you for your interest in this matter and for holding this particular hearing. If I might just make two or three observations, the reason I think BTT is such an important concept and should be part of the tax reform package is that it meets a number of critical needs. First of all, I think it is a very, very important factor—or could be a very, very important factor—in leveling the trade picture. BTT is valid under the GATT, but it would help our people export and perhaps even more importantly, put our American manufacturers selling in our own markets on a more even keel. So, I think it is a very, very important matter from that standpoint. Second, it will give us additional revenue that I think can be used to reform some of the proposals of the administration. I think one reason that the tax package has not set off is because it has no advocate. Middle America is concerned about because it sees its taxes as possibly being raised; and indeed, from the administration's own point of view, one out of three face a tax increase. So, it would enable us through this additional revenue to lower taxes to marginal rates. I propose, from something like the 15- to 25-percent range, most of American being at the 20 percent. It would enable us to promote savings, which I think is critically important, as a source of new capital to help our industries become competitive. And most importantly, it would enable us to reform some of the corporate proposals. I think the thing we have got to keep in mind, Mr. Chairman, as we look to reform is what kinds of tax policies are going to enable us to be competitive in world markets. How are we going to enable not only our high technology but our basic industries once again to compete, not only here but abroad as well? And I look forward to the hearing today, and thank you for holding it.

The CHAIRMAN. Thank you. Our first witness today is our old friend, Senator Rudy Boschwitz from the State of Minnesota.

Senator.

## STATEMENT OF THE HONORABLE RUDY BOSCHWITZ, U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator BOSCHWITZ. Mr. Chairman, I know that you don't want all 100 Senators coming here and speaking to your committee. I feel a special privilege in your case because you were so responsible for getting me here in the first place, so now that I am here you will have to listen to me.

The CHAIRMAN. I have to interrupt. Rudy is unduly generous in his praise. He is one of the few candidates I ever met in my old days as Senatorial Committee Chairman who had about a 75-percent name identification when he entered the race. In connection with his "Plywood Rudy" business, Rudy did his own advertising, appearing on television for years and years and years in his checkered shirts and big smile. By the time he ran for the Senate, any poor devil who was going to run against him was beaten from the start.

Senator BOSCHWITZ. And that is what he was, Mr. Chairman. [Laughter.]

But in any event, I am a businessman, as you know. In all my life, I have never run for any office other than this. I came here as a businessman, so, I approach the business of the Senate from that kind of a background.

I look upon tax bills and the changes that we make in the laws somewhat differently. I believe that we really don't understand the economic impact of our deeds very often. As we were talking before the hearing began, the importance of the Gramm-Rudman-Hollings bill that we passed yesterday is that we will now reduce deficits on a schedule. I agree with Lord Keynes that, if you spent more than you take in over a period of time, you probably create a good deal of economic activity. So, in the event that we do what we must do—balance the budget—we are going to dampen economic activity, in my judgment. It is not clear to me that we won't be creating something of a double-whammy if we pass a tax bill that may also have a dampening impact.

Let me start, Mr. Chairman, by saying, as I said at the White House recently when a number of us met with the President, that I don't particularly share his enthusiasm for tax reform or for making tax changes. One Senator once said that he was kind of satisfied with the tax law as it is; and to a certain extent, I share that feeling. I do not agree with the President that our tax law is inherently unfair, un-American. Also, I disagreed with President Carter when he said our Tax Code was a disgrace to the human race, or other things like that.

I gave you, Mr. Chairman, a copy of an article, and I hope that Senator Roth has one as well: "The Redistributionist Tax Reduction," which appeared in the Wall Street Journal in June of 1984. It shows that, when taxpayers are divided into four quarters, our tax system is quite progressive. The top quarter of the taxpayers, on the basis of their income, paid 72 percent of all the income taxes collected in this country and the bottom half paid 7.6 percent. So, there is a certain equity. Again, the top one-quarter paid 72 percent; and that, I think, shows a certain equity in the tax law as it now exists. I don't think it is inherently unfair. I noticed in this article, "The Redistributionist Tax Reduction," that the top 1.4 percent of all the taxpayers paid about 21 percent of all the taxes collected in 1981. So, I think our graduated tax system indeed works.

And, it is interesting to note that, when tax rates are lowered—and I am a great proponent of lowering tax rates—that the people with the highest incomes bear an even larger share of the total tax burden. This is an article written by Michael Evans entitled "Taxes, Inflation, and the Rich." I think you also have a smaller

copy, Mr. Chairman. He points out that as a result of the Kennedy tax reduction, lowered the top marginal rate from 91 percent to 70 percent, he charts the dollars that were paid by taxpayers in 1961, 1962, and through 1966. Those taxpayers with an income of over $100,000 a year—that is still a lot of money, but in those days it was a particularly large amount—paid a substantially greater amount of taxes as the rates were lowered.

So, I am very, very much in favor of lower tax rates. On the other hand, I am not in favor of more fooling around with the Tax Code, which we have done. I am not going to back and review the tax bills of 1981, 1982, 1983, and 1984. But, I think that taxpayers are just reeling from the tax changes in the past few years. Many people believe—and I tend to agree with them—that one of the things that we should do with respect to the Tax Code is nothing. Despite the fact that there may be some things that should be changed, I think we should approach tax reform on the basis of not doing very much or doing nothing at all. I note that the President's proposal would have an extraordinary impact on the total flow of funds. Individual income tax cuts would be almost $500 billion. Increases for individuals would be about $350 billion. Corporate tax cuts would be about $200 billion, and corporate tax increases would be about $300 billion. If you add all that up, the total is over $1.3 trillion. Put another way, during a 5-year period, we are impacting somewhat over half of the taxes that we are going to collect. And I go back to my original statement, that we really don't know the economic impact of our deeds here, particularly when we legislate about taxes. When we impact such a large a flow of the tax revenues, I think we do so with a good deal of risk to the economy. And, in my judgment, we can't chart and don't understand all the risks involved.

I also think that certain aspects of the major tax reform proposals confiscate value from taxpayers. Extending the depreciation periods is one example. I must say that I, myself, am reeling. When I was building buildings, most of the buildings I owned had a 40-year depreciation schedule. I came here very much in favor of the 10–5–3 system, which eventually became 15–10–5–3. I remember all the statements that I and others, and perhaps yourselves made on the Senate floor and to our constituents about the need to simplify and encourage Capital formation. Now, we are going to go back—not all the way to 40 years perhaps—but certainly, we are going to change it again. I think that those changes will probably confiscate a lot of value in real estate and have some effects that we don't realize right now.

As you know, Mr. Chairman, I came and talked to you one day about my thoughts that changes in the tax laws should be gradual. I thought that, rather than indexing the brackets upward, so that the brackets move up with inflation, that we should index the rates downward. That could work against the people in the lowest brackets, so there would have to be some adjustment to that scheme. But, the idea is to lower the tax rates over a period of years through indexing them down, either by the rate of inflation or in a staged way. And then, when the top rate gets to be maybe 40 percent, one specific group of exemptions, deductions, credits, or other benefits would be removed. Then, when the rates are reduced to 35

or 32 percent, another group would be removed, and so on, until the rates were the lowest possible. As we lower the rates over the years, the various benefits in the Tax Code would become less and less valuable, and I think many of them could be more easily removed.

But people should be able to plan, and I think that the way we are now treating the Tax Code, they cannot plan with any certainty. My votes on tax reform will be cast in that way—the need to allow people to plan. I wrote to you, too, Mr. Chairman—and I thank you for your response—about the "Standstill Tax Act of 1985," that professor Richard Doernberg from Emory University wrote about. He suggests that any provision of the tax law can be excised all together, or any number can be changed. You could do that, but you can't change any word. I think that that is not too bad an idea, even though it may have been written tongue-in-cheek. I would add, however, that you can't change any number upward, but only lower the numbers, and that it should be phased-in over a period of time. I agree with my friend, Prof. Milton Friedman, who says that if you just lower the rates, you don't have to fool around with all the changes and the so-called loopholes, most of which we legislated, because they will become less and less useful, less and less used, and they can be excised from the code in a more orderly manner. I have spoken to Professors Hall and Rabushka, and I need to speak to them some more. I think their flat tax proposal is the best thought-through of any of those approaches to the tax law.

I am an incentive economist in this, Mr. Chairman. I respond, and all my life I have responded, to economic incentives. That's why I like the idea of lowering the tax rates. I also like the idea of encouraging capital formation. I am tempted, for instance, to simply suggest that we just change the personal exemption, not to $2,000, but to a $300 credit, which would save a great deal of money. Then, use the money that is saved entirely for capital formation. Take all taxes off savings. And reduce capital gains rates by half, which would not be favored by all Members of the Senate by any means.

But I think, Mr. Chairman, that in the end, the country that taxes the least, taxes most fairly, and puts the greatest emphasis on capital formation is the country that will achieve the things that Senator Roth just spoke about. That country is the country that will have a competitive and healthy economy, that will attract capital, that will attract entrepreneurial talent, and that will attract the whole dynamism of free economics. And so, it would be my hope—and I come without a specific plan—that we don't fool around with the Tax Code too much, that we do indeed encourage capital formation, and that we lower rates. But very frankly, Mr. Chairman, the less we do, in my judgment, the better. Thank you.

The CHAIRMAN. Rudy, you continue to be one of the most imaginative people around here in a variety of areas. I have been consistently intrigued with your idea of ratcheting down the rates, rather than indexing the other way. Senator Roth?

Senator ROTH. I have no questions, Mr. Chairman. I am anxious to sit down and discuss with Rudy my latest proposal, which among other things would continue to lower the marginal rates. I think

that is critically important as part of a package, and I have to say I also strongly agree with you. One of my concerns is that we have had a tax package every year, practically, and that makes it impossible for the private sector to function effectively. I appreciate your taking the time to discuss it.

Senator BOSCHWITZ. Thank you, and I will come around very soon. I have something to talk to you about, too. [Laughter.]

Senator ROTH. I am first.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Thank you, Mr. Chairman. It is good to see Senator Boschwitz here. I am sorry I got here late. I don't have any profound questions to ask.

Senator BOSCHWITZ. It was profound.

Senator DANFORTH. I am glad to see you here. Thank you.

The CHAIRMAN. Rudy, thank you.

Senator BOSCHWITZ. Thank you very much.

[Articles from the Wall Street Journal and the New York Times follow:]

Wall Street Journal
MONDAY, AUGUST 7, 1978

# Taxes, Inflation and the Rich

by MICHAEL K. EVANS

Increasing numbers of economists have recently suggested that massive tax cuts might help millions of the U.S. economy by increasing productivity, raising investment and hence expanding aggregate supply. The idea of supply side incentives has been embodied in proposals like the Steiger amendment to cut capital gains taxes and the Kemp-Roth bill for an across the board tax cut.

These bills, and the new supply-side thinking these ideas that sound startling in the context of contemporary economic thought. Is it possible to cut taxes without spurring inflation? And is it possible to cut [illegible] taxes, without even reducing total revenues received by the federal Treasury?

The historical record clearly indicates that the rate of inflation is inversely proportional to the gap between actual and maximum potential GNP. So measures that raise potential GNP would reduce inflation at the same time they increase economic growth. Measures that succeeded in expanding the gap by raising potential would clearly offer greater benefits to society than the traditional remedies of fiscal and monetary restraint, which expand the gap by reducing aggregate demand.

### How a Tax Cut Reduces Inflation

In order for a tax cut to reduce inflation, it must increase maximum potential GNP faster than actual GNP. This is accomplished only by raising the investment ratio or by increasing incentives to work because a larger proportion of income will remain after taxes. Not all tax cuts accomplish this. A tax reduction of $50 per person, for example, would have no measurable effect on productivity or incentives, so it would not raise potential GNP. However, it would increase actual GNP, hence reducing the gap and raising the rate of inflation.

Thus the other extreme, a reduction in corporate income taxes or capital gains taxes would initially affect investment, thereby leading to the desired effect on productivity and total supply. While actual GNP would obviously rise because of higher capital spending, the gap would increase, thereby reducing the rate of inflation. A number of studies by Chase Econometrics and others have already shown the favorable impacts of business tax cuts.

The question of personal income tax cuts, which has become particularly relevant in view of the increased interest in the Kemp-Roth bill, is a much more difficult one to answer. While it may be theoretically appealing to argue that a reduction in personal income taxes encourages an individual to work harder and thus increase both his pretax and aftertax income, little evidence has been assembled either to support or disprove this hypothesis.

One of the major problems is measuring the amount and intensity of work offered by an individual taxpayer. However, a reasonable proxy variable is the amount of income taxes paid by this individual. Thus we can examine what happened to federal personal income taxes by income classification in the years following major tax cuts. These occurred in the mid-1920s, under Treasury Secretary Andrew W. Mellon, and in 1964-1965. It is interesting to examine both of these periods in some detail.

Before the U.S. entered World War I, the maximum tax rate on personal income was 15%, but this rate rose dramatically to a peak of 73% in 1918 and succeeding years. It was then cut to 55% in 1922 and 25% in 1926. It is instructive to learn what happened to taxes paid by millionaires—that group which has been singled out by President Carter and Treasury Secretary Blumenthal as unworthy of further tax relief. To adjust for the differentials caused by inflation, we consider those taxpayers with incomes over $500,000 in 1922 and in 1927, although even this adjustment is an understatement of the true effects of rising prices. In 1922, this group paid taxes of $77 million, while in 1927, the year after the second reduction in rates, its members paid a total of $230 million. Not only did the economy benefit significantly, but the millionaires themselves paid three times as much in taxes with lower rates.

It could be argued that the Mellon tax cut results, while instructive, are not relevant today since the institutional structure and income distribution of the U.S. economy are far different now than they were in the 1920s. However, we need not be restricted to a reading of "ancient history" in our determination of how a reduction in top bracket rates might affect overall revenues. Fortunately we can rely on the figures before and after the Kennedy-Johnson tax cuts of 1964.

As most readers will recall, the top rate was reduced from 91% in 1963 to 77% in 1964 and 70% in 1965 and later years. The figures for actual income tax paid for the period 1961-1966 for taxpayers with incomes of $100,000 or more are taken from "Statistics of Income" and are reproduced in the accompanying table.

The results are so clear-cut that it is surprising that these figures have not previously been introduced as evidence in favor of Kemp-Roth. After virtually no growth in income taxes for incomes over $100,000 for three years, actual taxes paid rose dramatically beginning in 1964 even though income was taxed at significantly lower rates. In the case of individuals earning over $1 million per year, taxes collected actually doubled in the two year span during which the tax rates were being lowered. For income classes under $100,000, taxes either fell or rose less than the average growth in total personal income.

*After virtually no growth in taxes collected from personal incomes over $100,000 for three years, actual income taxes paid rose dramatically beginning in 1964, when personal income was taxed at significantly lower rates.*

| | 1961 | 1962 | 1963 | 1964 | 1965 | 1966 |
|---|---|---|---|---|---|---|
| Maximum tax rate | 91% | 91% | 91% | 77% | 70% | 70% |
| Taxes collected from income classes of* | | | (in millions $) | | | |
| Over 1,000,000 | 342 | 311 | 326 | 427 | 603 | 590 |
| 500,000-1,000,000 | 297 | 243 | 343 | 306 | 408 | 457 |
| 100,000-500,000 | 1970 | 1740 | 1890 | 2220 | 2752 | 3176 |

*Adjusted gross income.

2,609 2274 2459 2,953 3,763 4,223

These results, which represent a remarkable rebuttal of those who argue that upper income tax cuts are a "raid on the Treasury," indicate that a further reduction from 70% to 50% would not only spur economic growth and increase aggregate supply, but would actually assure the Treasury of greater tax revenues. The argument for upper-income tax cuts is almost as watertight as the argument for lower capital gains taxes.

The more extreme proponents of Kemp-Roth have sometimes seemed to suggest that this phenomenon occurs at all income levels. It does not, as can be seen by a perusal of the complete "Statistics of Income" figures, and by the fact that aggregate personal income tax collections did decline from $51.5 billion in 1963 to $48.6 billion in 1964. This should come as no great surprise: The effects on individual incentives and supply of labor are undoubtedly much greater where taxes are highest—at the upper income levels rather than for the typical wage earner.

### Flexibility for Upper Income Group

Furthermore, just as has been shown in recent work on capital gains taxes, upper-income individuals have far greater flexibility in arranging the income for their assets in the form of tax-free or tax-sheltered income when tax rates are at punitively high levels. The risks of unreported income become relatively much smaller when tax rates are near 100%, and the lure of diverting earnings to foreign countries becomes much greater.

Thus if the Treasury wants to collect more revenues, it will lower the highest marginal tax brackets. Only if it wants less revenue and poorer economic growth so badly that it is willing to penalize all those "millionaires" will it push for higher upper income tax rates.

*Mr. Evans is president of Chase Econometric Associates Inc.*

# The Redistributionist Tax Reduction

WALL STREET JOURNAL 6/26/84

By James Gwartney
And Richard Stroup

Despite the appearance already of telling analyses of 1982 Internal Revenue Service data, some observers have difficulty understanding that a roughly proportional reduction in tax rates will shift the burden of the income tax toward the upper income brackets. Yet this is precisely what both economic theory and our experience with major rate reductions indicate. The latest cut is no exception, as we can show with a new perspective on the recently released 1982 numbers.

Contrary to the assumption of many, taxable income is not invariant to changes in tax rates. When tax rates decline, the take-home pay per dollar of additional earnings increases. Taxpayers have more incentive to earn additional income and less incentive to engage in tax-sheltering activities that now generate less tax-saving. As a result, lower tax rates lead to an expansion in the tax base.

## A Straightforward Answer

The incentive effects of an across-the-board rate reduction will differ across tax brackets. It will have a leveraged impact on the incentives of high-income taxpayers. Perhaps some numbers will make this point clear. Suppose tax rates are cut across the board by 20%. In the 10% bracket, the rate is cut to 8%, while a 70% rate declines to 56%. Now, consider how this proportional rate reduction affects take-home pay. People in the 10% bracket take home 92 cents instead of 90 cents per dollar of additional earnings, a paltry 2.2% increase. Clearly, this small increase is unlikely to exert a major impact on the incentive of those taxpayers to earn more taxable income. In contrast, look at what happens in the 70% bracket. Here the 20% rate reduction boosts take-home pay to 44 cents per dollar of additional earnings from 30 cents—a 47% increase. Taxpayers in this and other high income brackets are now permitted to keep a significantly larger proportion of an added dollar of income. Predictably, they will respond by earning more taxable income and engaging less intensely in tax-shelter activities.

How does this incentive structure affect the distribution of the tax burden across income groupings? The answer is now straightforward. Since the rates were all reduced by the same percentage, the leveraged impact of incentives means that the size of the revenue reduction will be inversely related to the changes in taxable income. If taxable income is virtually unaffected by the rate reductions, as is likely to be the case in the lowest marginal tax brackets, revenues will fall by approximately the same percent as the rates. In these brackets, a 20% rate cut will lead to about a 20% reduction in tax revenues. In contrast, in the upper income (and marginal tax) brackets where the incentive effects on take-home pay are greater, increases in the tax base will at least partially offset the lower rates. In these brackets, tax revenues will fall by less than the 20% rate reduction. The result—an increase in the share of taxes collected from high-income taxpayers.

**Effects of Reagan Tax Cut on Rich and Others**

| Income Grouping* | Income % | Tax Liability ($ billions) 1981 | % | 1982 | % Change |
|---|---|---|---|---|---|
| Bottom 50 percent | 7.6 | $ 21.7 | 7.5 | $ 19.5 | −10.1 |
| 50 to 75 percentile | 20.9 | 59.0 | 20.9 | 55.6 | − 5.8 |
| 75 to 98.6 percentile | 51.3 | 145.4 | 51.9 | 141.3 | − 2.8 |
| Top 1.4 percent | 20.4 | 58.0 | 21.6 | 60.5 | + 4.3 |
| | | 284.1 | | 276.9 | |

*The number of returns in each income grouping was virtually identical in 1981 and 1982.

The distributional effects of a tax cut can best be observed by comparing the revenues collected across the income distribution before and after the rate reduction. The accompanying table makes this comparison for the 1981-1982 data. The bottom 50% of income recipients paid $19.5 billion in personal income taxes in 1982, down from $21.7 billion in 1981, a 10.1% decline. Even though the rate reductions for taxpayers in the 50th to 75th percentiles and 75th to 98.6th percentiles were similar to the rate cuts in the lower brackets, the decline in tax revenues collected from these groups was smaller, just as economic theory predicts. For the higher income groups, an expansion in the taxable income base partially offset revenue losses due to the lower rates. Thus, tax revenues fell by smaller amounts in the upper income brackets.

The imposition of the 50% rate ceiling in 1982 reduced tax rates by as much as 28.6% (to 50% from 70%) in the highest income brackets. The top 1.4% of taxpayers were most directly affected by this rate reduction. At the lower rates, the *taxable* income of the top 1.4% of returns grew sharply in 1982. In fact, it grew so sharply that the tax revenues collected from this small group of high-income taxpayers increased to $60.5 billion in 1982 from $58 billion in 1981. While revenue collected from all other groups fell, the tax liability of the top 1.4% of income recipients increased.

Clearly, the share of taxes collected from the rich rose in 1982. The top 1.4% of taxpayers shouldered 21.8% of the tax burden in 1982, up from 20.4% in 1981. In contrast, the share of total income-tax revenues contributed by the lower half of income recipients fell to 7% in 1982 from 7.6% in 1981.

Unwilling to admit that incentives matter, critics have offered two alternative explanations. Some have argued that the shift in the tax burden toward the rich was the result of the 1982 recession. Of course, a recession does reduce incomes. However, there is no reason to believe that the income reductions are greater in lower tax brackets than in upper brackets. In fact, the instability of business and professional income over the business cycle would suggest the opposite, that a recession is likely to retard income in the upper brackets more severely.

The most damaging evidence against the cyclical view is provided by the 1963-65 data. During this period of economic boom, the distributional pattern emanating from an across-the-board rate reduction was identical to the pattern due to the 1981 tax cut. When the rates were reduced in 1964-65, the tax revenues collected from the top 5% of taxpayers rose 10.9%, while the revenues collected from the bottom 50% of income recipients fell 6.4%. As in 1981-82, the 1963-65 data indicate that a roughly proportional rate reduction shifts the tax burden to the rich.

Second, other critics have argued that the increase in the share of revenues collected from the rich [illegible] capital gains associated with the stock market boom that began in August 1982. Inspection of the data reveals that this is a "tail wags dog" theory.

Capital gains are a small part of total income. In 1981, net capital gains contributed only 1.7% to total adjusted gross income (AGI). Even for the top 1.4% of taxpayers, the capital-gains component was only 9.6% of AGI. Given the size of capital gains as a share of AGI, it would have taken a huge expansion in capital-gains income to explain the observed pattern of income growth across income groupings in 1982. But the actual increase in net capital-gains income was rather modest—to $32 billion in 1982 from $29.3 billion in 1981, an increase of only 9.2%. Of course, the major component of income is wages and salaries. This component grew substantially more rapidly in the upper tax brackets between 1981 and 1982. Clearly, it provided the major impetus for the growth of taxable income in the upper brackets.

## Responsive Tax Base

The 1982 data indicate that the tax base is quite responsive to changes in tax rates, particularly in the upper tax brackets. Given the economic environment, the responsiveness is almost surprising. After all, the rate reductions did little more than correct for bracket creep and higher Social Security taxes. In addition, the more rapid depreciation allowances provided by the 1981 legislation actually increased the attractiveness of tax-shelter investments. Finally, all the talk about higher future taxes did little to discourage the tax-shelter industry. Had it not been for the more rapid depreciation write-offs and constant threat of higher future tax rates, the tax base in the upper brackets would surely have grown by an even larger amount. Far from suggesting that the marginal rates were cut too much, the data indicate the potential of still lower marginal rates. Sens. Bill Bradley and Robert Kasten, along with Reps. Jack Kemp and Richard Gephardt, should take note and push on with their plans for genuinely lower rates.

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# Forum

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## ENDING REFORM ONCE AND FOR ALL

# Proposed: Tax Stand-Still Act of

By RICHARD L. DOERNBERG

ADVOCATES of tax reform use a simple but beguiling logic: We have a lousy tax system; let's fix it. I am now convinced that we should follow a less obvious logic: We have a lousy tax system; let's leave it alone or it will get worse.

Tax reform is a political impossibility in our country. The choice of words is important. Reform is an impossibility, not just a formidable task. That's why I am proposing the Tax Stand-Still Act of 1985 and Beyond, which would assure that no new provisions or language would be added to the Tax Code — ever.

Our political institutions, which have served us well in many areas, cannot produce an improved tax system. How do I know that? History tells me so. From its inception in 1913, the Federal income tax has grown in reach and complexity. In the name of reform, every Congressional change in the tax laws has heightened the complexity. The legislative motive is always pure; the result is always an early Christmas for accountants and tax attorneys. Consider the following Congressional language:

> "The purpose of the bill, as reported, is to improve our existing revenue system, to remove inequities, to equalize the tax burden, and to stimulate business activities, and to accomplish this without reducing the revenue which would be obtained by existing law under present conditions. . . . In making its recommendations, the committee has also given special attention to changes which will simplify the law and increase its certainty."

This noble quotation sounds like something President Reagan or Representative Daniel Rostenkowski might have said in the tax debate, but actually it is taken from committee reports accompanying the Revenue Act of 1938. There is very little new under the tax reform sun.

Yet, we seem to think this time will be different. So too did the generations that preceded us. The names of previous tax acts are a haunting epitaph to the loftiest of Congressional aspirations: the Tax Reform Acts of 1969, 1976 and 1984, the Tax Reduction and Simplification Act of 1977, the Tax Equity and Fiscal Responsibility Act of 1982.

Why should this time be any different? Do proponents think that moving from 15 to 3 graduated rates is a meaningful simplification? If my optometrist decreases the number of lines on the eye chart, it doesn't mean I can see any better. No, there is no reason to believe that tax reform in 1985 will fare any better than its predecessors.

Those who have advocated tax reform (including the author, before reality intruded on his fantasy) have written incessantly of the inefficiencies and distortions of our current system. Economists have produced studies proving beyond doubt the merits of both sides in every debate on our current laws. For every study demonstrating convincingly that the result of a change will be "A", there is a study that shows the result will be "not A." The reason is simple enough. Life is too complicated and there are too many variables for us to accurately predict what effects our tax system has on the economy.

However, there are some economic effects we can specify with great certainty and clarity: The very real and staggering transaction costs of switching to another tax system. These costs would include retraining and retooling the Internal Revenue Service bureaucracy, the imposition on millions of taxpayers of learning a new tax system and the implications of a new tax system for commercial transactions both future and past. I prefer the certainty of saving these real costs to the uncertainty of an "improved" tax system. I see history nodding its approval of my position.

But I am also realistic enough to know that Congress will not leave the system alone. With that in mind, I offer the Tax Stand-Still Act of 1985 and Beyond.

The act consists of two simple propositions. First, if Congress wants to raise additional revenue it can either eliminate existing deductions or change any number in the Internal Revenue Code (increase tax rates, for example, or decrease depreciation rates, increase a floor, decrease a ceiling). No new provisions, no words can be added to the code.

SECOND, if Congress wants to raise less revenue, it can either eliminate existing inclusion provisions or change any number in the code (decrease tax rates, shorten depreciation periods, increase personal exemptions). No new provisions, no words can be added to the code.

The size and complexity of the code would remain at a stand-still or even shrink, if Congress eliminated deduction or inclusion provisions. Congress would be free to substitute one number for another in any code provision. Tax rates could move up or down, depreciation rates could move up or down, depreciation periods could change, numerical ceilings and floors could change. Congress would have

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The CHAIRMAN. Now, if we can take a panel of Michael Schuyler, R.S. Miller, Jr., John Meagher, and James Mack. As all of the witnesses who are familiar with the committee know, while we have been unsuccessful in putting time limits on the oral presentation of Senators, we do ask that the other witnesses submit their statements for the record in their entirety, and abbreviate their oral presentation to 5 minutes. We will start with Mr. Schuyler.

**STATEMENT OF MICHAEL SCHUYLER, ECONOMIST, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC**

Mr. SCHUYLER. Thank you, Mr. Chairman. My name is Michael Schuyler. I am an economist with the Institute for Research on the Economics of Taxation, IRET. The views I will express this morning are my own and not necessarily those of IRET.

I would like to begin by saying that I am pleased to appear before this distinguished committee. This committee is to be congratulated for the care it is taking in examining the issue of tax reform and for the contributions to the debate that it is making. The subject of tax reform deserves this cautious and thorough approach because even the best tax plan will have disadvantages of which we should be aware. For example, it would subject taxpayers to numerous transition costs. As to less worthy plans, however well intentioned, they would retard rather than advance tax reform goals like growth, simplicity, and fairness. The administration's tax plan contains some very attractive but costly features, like income tax rate reductions, and some very controversial revenue-raising elements that are intended to maintain the plan's overall revenue neutrality. Therefore, although the administration's plan currently holds center stage, it is extremely important to consider tax reform alternatives.

An alternative with several very desirable economic properties was introduced in May of this year by Senator William Roth. It is known as the Business Transfer Tax, abbreviated BTT. The BTT has recently been revised and would now form a part of a larger tax reform package. The BTT would be a single rate levy of probably 7 to 10 percent on each business' value added, where value added is the difference between the value of the business' sales and the value of its input purchases from other businesses. At a 10-percent rate, its net revenues are estimated to be slightly over $100 billion in 1986, of which about 20 percent would come from imports. The BTT would allow taxpayers to calculate their tax liabilities by the subtraction method, which is simpler than the invoice credit method usually associated with value added taxes. The tax would exempt the sale and rental of residential housing, land, the retail sale of food for off-premises consumption, medical services, and the activities of charities and governments. Like most taxes of this type, the BTT would make border adjustments to add imports to the tax base while removing exports.

The BTT would be more successful than most current U.S. taxes in meeting many of the goals of tax reform. First, it would be free of the present system's tendency to encourage immediate consumption, at the expense of saving and investment. Second, it would

treat United States and foreign products on the same footing, avoiding features in the current U.S. tax system that hobble U.S. products compared to their foreign competition both at home and abroad. Third, it would be a relatively simple tax because it would draw heavily upon information already gathered by taxpayers for income tax and internal bookkeeping purposes. Most likely, the BTT would not be passed forward to consumers in the form of higher prices but be passed backward to the workers and investors involved in the production process, in rough proportion to their pretax incomes. Thus, the BTT would not be a regressive tax but an approximately proportional tax on labor and capital incomes.

Perhaps the greatest danger of the BTT is its immense revenue potential. A subsequent rise in the BTT's rate could fuel a surge in Government receipts and expenditures.

In its currently proposed form, most of the BTT's revenues would be used to lower individual and corporate marginal income tax rates, to reduce further some of the income taxes now collected from businesses, to establish new tax-deferred saving accounts for individuals, and to improve upon the capital cost recovery system proposed by the administration. These measures would reduce the tax system's bias against saving and investment and would lessen a wide range of distortions contributed to by high marginal tax rates. Perhaps, however, the first priority for the BTT's revenues should be to replace many of the unappealing revenue raisers now in the administration's tax plan. The administration's revenue-raising suggestions include, for example, the repeal of ACRS and the ITC, the elimination of State and local tax deductibility, and the numerous industry specific changes that would greatly increase capital costs in certain sectors of the economy. Because many of the administration's revenue gaining proposals move away from the goal of tax reform, using the BTT to finance the desirable portions of the administration's plan would produce a fairer, simpler, and less distortionary tax system.

At the pleasure of this committee, I would be glad to submit for the record a paper I originally prepared for an IRET roundtable on tax reform alternatives that discusses in greater detail the preliminary version of the BTT. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Miller, a man who has old Portland connections. It is good to have you with us.

[The prepared written statement and the paper for IRET of Mr. Schuyler follow:]

Testimony Before the Senate Finance Committee

Congress of the United States

Michael A. Schuyler
Institute for Research on the Economics of Taxation
(IRET)

# Evaluating the Business Transfer Tax (BTT) As a Means of Financing Tax Reform

October 10, 1985

My name is Michael Schuyler. I am an economist with the Institute for Research on the Economics of Taxation (IRET). IRET is a non-profit institute whose primary purpose is to analyze the tax system, particularly the effects taxes have on our individual incentives, to work, consume, and invest. While the views expressed here are my own, much of the work undertaken at IRET has addressed the subject of tax reform.

I am pleased to appear before this distinguished committee. This committee is performing a commendable service in examining so thoroughly the subject of tax reform and in seeking out, as well as initiating, such a broad range of ideas.

The tax reform proposal I will be discussing is known as the business transfer tax (BTT). As presently conceived, the BTT would be a levy on the difference between a business's sales and its purchases from other businesses. The tax would probably be set at a rate between seven and 10 percent. It would be deductible as a business expense for income tax purposes. The BTT merits attention both because it possesses attractive economic properties and because it has been developed into a concrete legislative proposal. Senator William Roth introduced the BTT in legislative form (S.1102) earlier in the present session of Congress; he has since completed substantial modifications aimed at integrating it within an overall tax reform program.

**The BTT's Structure**

The BTT would be collected from the business sector. A business would find its tax base by taking the difference between its sales and its purchases from other firms. The business would then find its tax liability by multiplying its tax base by the tax rate. The rate has not yet been established but will probably fall between seven and 10 percent. It would not be refundable but could be carried forward for up to 15 years. In the revised bill, the BTT would be a deductible business expense against corporate, partnership, and sole proprietorship income.

The tax base would be adjusted in several respects. Two of the adjustments concern exports and imports. Exports would be excluded from the tax base while imports would be taxed on their value when they enter the country. The intent of these border adjustments is to exclude the value of exports from the tax base while including the value of imports. Several retail activities would not be taxed. These include the sale or rental of residential housing, medical services provided to patients, and the retail sale of food for off-premises consumption. These exemptions are allegedly made on equity grounds; they unquestionably have political appeal. Charities and governments also would not be liable for the tax on their activities. The revised version of the BTT also promises to exclude from the tax the activities of very small businesses; details are not yet available.

In the revised proposal, the BTT's revenues would be used to finance a variety of tax reforms. Most dramatically, they would be used to lower personal income tax rates to 15, 20, and 25 percent and to lower the top corporate rate to 30 percent. The emphasis throughout is on lessening tax disincentives that now inhibit saving and investment.

An economist would classify the BTT as a consumption-type value added tax (VAT). A consumption-type VAT is a levy collected from each firm along the production chain based on that firm's value added. A business's value added is the difference between the value of its output and the value of the inputs it purchases from other firms. For instance, if a retailer has sales of $40,000 and input purchases from its suppliers of $30,000, its value added is $10,000. In order to avoid overcounting value added, it is crucial that a business be allowed to deduct its input purchases from other firms. Some of the most important inputs are capital goods. A consumption-type VAT treats capital goods like other input purchases and permits their immediate deduction. If capital goods could not be deducted or could be deducted only after a delay, the tax would discourage firms from using capital goods in the production process because in present value terms the tax base would include both capital goods (at least in part) and the value eventually added by those capital goods.

Many nations, especially in Europe, have been using VATs for years. In terms of its tax base, the BTT would resemble these levies; with respect to how taxpayers would calculate their liabilities, however, the BTT would be very different. Whereas most VATs use a credit mechanism for allowings firms to remove their third-party purchases from their tax bases, the BTT would use the more direct subtraction method. Although the subtraction method provides less of a paper trail for tax enforcers to follow, it meshes nicely with the information that U.S. taxpayers must already assemble in computing their income taxes. To prevent confusion, then, it should be understood that a VAT, which is defined by its tax base, need not adopt the European collection procedure. (To prevent confusion on another front, it should also be understood that the term "VAT" does not imply a tax that is shifted forward to consumers. In fact, an analysis of aggregate money spending in the economy suggests that a VAT will be shifted backward to the workers and producers involved in the production process.)

**Economic Properties of the BTT**

Serious conflicts are inherent in even the best designed tax system. Taxes are a means to an end: they help finance government expenditures. In doing this, unfortunately, a tax system tends to reduce work incentives, is all too likely to discourage capital formation, may impair the competitiveness of U.S. products in international markets, is prone to saddle

taxpayers with onerous compliance costs, and may violate basic notions of fairness. The objective of tax reform should be to continue raising the needed revenue while reducing as much as possible the economically harmful side-effects of taxation. From this perspective the BTT has a number of relatively desirable properties and compares favorably with major elements of the current tax system. Of course, a recognition of taxes' direct and indirect costs should still cause us to scrutinize government spending with extra care, asking if the benefits of particular programs outweigh all their financing costs.

The BTT's neutrality between saving and current consumption. Perhaps most importantly, the BTT would not encourage immediate consumption at the expense of saving and investment. Saving and investment are vitally important to all Americans because they provide the building blocks that an economy needs for long run growth. It is by means of saving and investment that the capital stock grows, that many new discoveries are made, and that new advances are incorporated into the capital stock. More tools, better tools, and superior production techniques are the fruits of saving and investment; they permit people to become more productive and to attain higher standards of living.

Unfortunately, the U.S. tax system harshly penalizes saving and investment. If an individual decides to save some earnings, the government taxes both the earnings themselves and later the returns on those earnings. If the individual directs those

earnings into a corporate investment, the tax system takes an additional bite in the guise of the corporate income tax. Inflation exacerbates this bias because the tax system treats the illusionary gains due to inflation as though they were real. Given the way in which the U.S. tax system artificially lowers the rewards for saving relative to the rewards for consuming immediately, it is no wonder that saving and investment rates in the United States score last or close to last among those of the industrialized nations.

The BTT would avoid this multiple taxation by taking care to tax value added only once. For example, if a firm purchases a capital good that it then uses in producing output, the BTT would only tax the firm on the value that it adds to its output. By virtue of the BTT's deduction for third party inputs, it would assess no separate, additional tax on the capital good. As a result, the BTT would avoid multiple taxation, maintaining its neutrality between saving and current consumption. This neutrality would renew people's freedom to plan for their futures without an artificial tax incentive to concentrate on the present.

Maintaining International Competitiveness. Another desirable property of the BTT is that it would do far less damage than most taxes to the competitiveness of American products in international markets. One reason for this stems from the BTT's neutrality between saving and consumption. Because the BTT does

not have an anti-saving bias, it would be less likely than many other taxes to retard the capital formation that U.S. producers need in order to remain as productive as their foreign rivals.

Another reason that the BTT would do comparatively little damage to U.S. competitiveness is that it would not force U.S. products to bear taxes that foreign products escape. This is the motivation for the BTT's treatment of exports and imports. The BTT removes exports from the tax base in order that they can be sold abroad without bearing a U.S. tax not carried by their foreign competitors. The BTT adds imports to the tax base so that they will shoulder the same tax as U.S. products sold domestically. These so-called border tax adjustments, which have the effect of taxing products according to where they are consumed rather than where they are produced, are a common feature of the VATs that many of our trading partners employ. For example, if a German good is sent to the United States, the German VAT would be rebated at the border.

As of now, the U.S. tax system puts American products at a disadvantage at home and abroad by failing to make these adjustments. In fact, for legal reasons contained in the terms of the General Agreement on Tariffs and Trade (GATT), these adjustments cannot be made by the U.S. income tax but could be done using a levy like the BTT.

One problem with the BTT's border adjustments is that the export exemption is only partial. If a product has passed through the hands of several firms before being exported, it is not enough to exempt the exporter's activities from the tax; the government must return the taxes paid at earlier production stages. The BTT permits this reimbursement only to the extent that the exporter's total BTT liability does not fall below zero. In other words, the BTT is not refundable. Although the reimbursement may be carried forward to future years, its value would decline rapidly in present value terms. For the many businesses that concentrate on exports, this restriction would limit their ability to employ border adjustments.

The current tax-induced lack of international competitiveness hurts U.S. producers and workers by threatening their profits, wages, and jobs. The danger is especially acute today because of the growing sentiment in the United States for protectionism. Protectionism is dangerous not only because it restricts consumers' purchasing options and gives producers an artificial sense of security but also because it invites retaliation. For instance, many believe that a protectionist trade war was one of the chief causes of the Great Depression. If used as a replacement for part of the current tax system, the BTT could serve as a constructive alternative to protectionism, benefiting U.S. producers and workers.

Price Stability. A frequently expressed concern is that a tax like the BTT might push up prices. The worry is that if an item cost, say, $50 before the adoption of a 10 percent BTT, it would cost $55 after the tax's imposition and that other products would experience similar price rises. An implicit assumption in this story is that producers can shift the tax forward to consumers.

However, producers are likely to fail in their attempts to pass the tax on to consumers. The stumbling block for producers is that a balance exists between the economy's supply of goods and services and the amount of money being spent to buy that output. If the economy is in a position where the current level of money spending is just sufficient to purchase the current level of output, producers could only raise their prices if either they were willing to sell less or they could persuade buyers to increase their money spending for consumption goods and services.

It is far from obvious that the introduction of a BTT would convince consumers to pay more for the same amount of goods and services, abandoning their old level of money spending on consumption for a higher one even though their incomes have not increased. Admittedly, if the Federal Reserve decided to accompany the tax with a monetary expansion, money spending would rise, but the cause would be money growth not the tax change. In the absence of a rise in money spending, producers would discover that if they raised their prices, they could no longer sell all of their output because there would be too little money spending

to buy it: buying the old output at the new prices would require more money spending than was previously sufficient. The unsold output and the consequent idling of resources would put intense pressure on producers to reverse their price increases. As a result, although producers would be desirous of passing the tax forward, they would probably be unsuccessful; the tax would tend to be passed back to them and to the owners of the resources they employ.

Notice that the key to this analysis is the relationship between output and money spending. Therefore, the argument is not specific to the BTT but can be applied to taxes in general whether they happen to be based on consumption, income, wealth, or some other variable.

The tax base does affect the outcome in one way, though. An efficient tax will tend to permit higher productivity and more output than an inefficient tax. Thus, if an efficient tax were to replace an inefficient one, the substitution would tend to boost real output. The gain in output, in turn, would tend to exert downward pressure on prices. For example, if the BTT (computed by any of the main techniques) were partially to replace the corporate income tax, the positive supply response would tend to lower prices.

Tax Fairness. Levies like the BTT are thought by many to be unfair. The accusation arises from the fear of some that the BTT

would be regressive, bearing more heavily on the poor than the wealthy. Regressive taxes tend to violate a standard of fairness known as vertical equity. By this criterion, the tax system should distinguish between individuals of different means, making the wealthy pay more taxes than the poor. Vertical equity is an extremely difficult criterion to quantify because people have reached no consensus about the degree to which tax burdens should differ according to means. Another standard of fairness is horizontal equity: individuals with similar levels of well-being in the absence of a tax should be treated equally by that tax.

A recognition that the BTT tends to be shifted backward helps to evaluate these concerns. Suppose as a rough approximation that the recipients of labor and capital income would bear the BTT in the same proportions as their respective contributions to value added. In this event, the BTT would be a proportional tax on labor and capital incomes rather than a regressive tax. People would pay the BTT in direct relation to the incomes they receive from the production process.

With respect to vertical equity, this analysis suggests that the BTT, while not a progressive tax like the individual income tax, is innocent of the charge that it would be regressive. With respect to horizontal equity, the BTT has an important advantage over an income tax. Suppose two people have equal incomes but differ in the extent to which those incomes represent remuneration for labor and capital services. An income tax would

violate the horizontal equity principle because it would tax the individual with the higher ratio of capital income more heavily than the other individual. The BTT, though, would pass this test because it would treat the two individuals equally.

Nevertheless, to combat charges of regressivity, the BTT would provide partial exemptions for food, housing, land, and medical services. If the tax were shifted forward, these measures would allow the poor--and also everyone else--to buy these "necessities" without paying the full tax. Although these exemptions may be politically sensible, the economic case for them is weak. Even if the BTT were shifted forward, it is not clear that these exemptions would mostly benefit the poor. Other income groups might actually be the main beneficiaries given that people frequently buy more of a "necessity" like housing as their wealth increases. If the tax is shifted backward, the exemptions would also miss the mark. The suppliers of exempt items, people like doctors, landlords, and grocers, would reap the initial benefits from the exemptions.

Regardless of whether the tax is shifted forward or backward, the exemptions are undesirable in two respects. One problem is that they complicate the tax code. They would force many taxpayers to make extra distinctions, sometimes arbitrary and complex ones, in their records and tax calculations. They would also compel the government to write additional regulations and complicate its enforcement responsibilities.

Another shortcoming of the exemptions is that they create a tax inefficiency. By putting less of a tax load on some items than on others, they encourage the overconsumption and overproduction of the favored goods and services. Suppose, for instance, that a business adjusts the production of outputs A and B until they yield the same return in the absence of tax considerations. If the government suddenly imposes a tax on A while exempting B, the business will shift its output mix towards B solely in response to the tax. To give credit where it is due, though, the BTT would still possess a far broader and more uniform tax base than most current levies despite its exemptions.

Simplicity. The BTT is a commendably simple tax. Taxpayers already gather most of the information required by the BTT for income tax and international record keeping purposes. The subtraction method by which the BTT would be calculated is a major plus. For taxpayers already used to income tax calculations, it would be much less confusing and generate much less new paperwork than would the European-style computation method. The BTT's single rate reinforces its simplicity. Unlike most European VATs, which contain a variety of rates that force taxpayers to separate their value added into a number of subcategories, the BTT would let taxpayers deal with a single tax base and a single tax rate.

The BTT's complexity is increased, however, by a number of exemptions of which taxpayers and the government would need to keep track. The revised BTT also provides an exemption for small taxpayers. An assessment of whether or not the small-business exemption will simplify the tax must await the release of more information on its rules.

Although the BTT would not actually reduce taxpayers' administrative burdens (unless it took the place of a more complicated levy), it is far simpler than many recent tax-reform suggestions.

Would the BTT increase the government's size? Unfortunately the BTT also has some unattractive features. The most worrisome matter for people concerned with controlling the size of the government is the immense revenue potential of a new, broad-based tax like the BTT. Once introduced into the tax system on a revenue neutral basis, it could, with its immense revenue gathering ability, later become a device for expanding tax collections and government spending.

This danger makes it imperative that the BTT not be enacted without an extensive public debate that emphasizes it is not to be used as a means for increasing total tax collections. Indeed, Senator Roth was sufficiently concerned about the possible misuse of the BTT's net receipts that he made the last section of S.1102 a sense of the Senate resolution "concerning use of BTT

revenues". The resolution states that the BTT's net revenues should be used as a means of funding income tax reform, not as a device for increasing aggregate government revenues. A complementary option might be to include in the bill a provision to limit the rate at which the BTT could be imposed, at least for the next several years.

State and local resistance. Many state and local governments view sales taxes as their domain and might regard the BTT as a federal encroachment. One response is that historically the federal government has itself relied heavily on excise taxes. It has never ceded this type of levy to other levels of government. Another response is to investigate whether the BTT would, in fact, diminish significantly the potency of state and local sales taxes. Perhaps the most relevant reply today is to ask how state and local governments would view the BTT if it were substituted for some of the revenue raisers now in the Administration's tax plan, particularly the proposed repeal of the federal income tax deduction for state and local taxes. If this substitution occurred, state and local governments would likely see the BTT as the lesser evil.

Changes in tax burdens. Any major tax revision will produce winners and losers throughout society and cause numerous economic disruptions. Because of these problems, tax reform should not be undertaken lightly or for small potential gains. For example, the revenue raisers in the Administration's tax package would

produce a variety of losers. To cite some examples, special provisions would hurt the banking, insurance, timber, and mining industries. The replacement of ACRS and the ITC with CCRS would damage capital intensive firms by raising the after-tax cost of capital; the "recapture" tax would inflict further harm on many of these firms. The elimination of state and local tax deductibility and new restrictions on municipal bonds would greatly strain the finances of state and local governments.

It is worth mentioning the shifts caused by the revenue raisers in the Administration's plan because the BTT is drawing attention as an alternative to some of those suggested tax hikes and as a means of carrying further some of the most desirable features in the Administration's plan, such as reductions in individual and corporate marginal tax rates. That is, in the context of the tax reform debate, the BTT should not be compared to an alternative involving no tax shifts but to one generating very large, but different, shifts.

If the BTT were used in this capacity, the changes it produced would depend on the extent to which it substituted for revenue raisers in the Administration's package (and which of them it replaced) and the extent to which it was used to finance additional (revenue-losing) tax reforms. Three general shifts in tax burdens deserve emphasis, however. One is that because the BTT would not engage in the repeated taxation of capital income, it would benefit capital intensive firms relative to their

treatment under the Administration's plan. Second, the border tax adjustments which are present in the BTT but lacking in the Administration's package would help U.S. exporters to sell abroad and help U.S. producers to compete against imports at home. Third, labor intensive firms would tend to do less well under the BTT because labor costs are included in the BTT's base (i.e., value added) but not an income tax's base. This last effect would be especially severe for inefficient firms with bloated payrolls. Because payroll costs are tax deductible under an income tax, the government, in effect, pays part of the cost of the firm's inefficiency.

**How to Use the BTT's Revenues**

In the revised version of the Roth bill, the BTT's revenues would finance a number of reforms aimed at reducing tax distortions, especially those currently inhibiting saving and investment. Only to a very limited extent would the BTT's revenues be used to replace the revenue gainers in the Administration's tax plan.

The centerpiece of the Roth program is to reduce individual and corporate income tax rates to below the levels proposed in the Administration's plan. As a result of this reduction in the tax wedge separating before-tax and after-tax rewards, people would have less of an incentive to alter their behavior solely for tax reasons.



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The BTT would achieve a further, albeit indirect, reduction in income taxes because BTT liabilities could be counted as deductible business expenses. For instance, a corporation with BTT liabilities of $5,000 would reduce its taxable income by that amount. At the proposed 30 percent corporate tax rate, this deduction would lower the corporation's tax bill by $1,500. This is a highly desirable substitution in terms of efficiency because it would partially replace a tax that strongly discourages investment with one that does not. In a way, the BTT's deductibility would also serve a role similar to that of a corporate minimum tax. Because only businesses with profits to offset could claim the deduction and the resulting tax saving, the corporations that were most successful in not paying corporate income taxes would derive the least benefit from the BTT's deductibility.

Another measure directed at the income tax system's anti-saving bias is a proposal to create tax-deferred saving accounts similar (and in addition to) IRAs but with fewer withdrawal restrictions and somewhat larger contribution ceilings. Millions of middle class Americans could use these accounts, together with IRAs and pension plans, to protect much of their saving from the multiple taxation normally characteristic of an income tax system.

The Roth package would also substitute the Expensing Cost Recovery System (ECRS) for the Administration's CCRS depreciation proposal. ECRS would allow 50 percent of an assets' basis to be written off in the first two years (this takes the half-year convention into account) with the remainder to be depreciated according to CCRS. How does ECRS compare with CCRS and the present combination of ACRS and the ITC? A comparison of the present values of the capital cost recovery allowances and of effective tax rates indicates that the current system provides more incentive for investments in equipment and machinery than would the other two systems. CCRS would be far less hospitable than ACRS-ITC; ECRS would be slightly better than CCRS. For structures (long-lived and generally not eligible for the ITC), CCRS would be superior to ACRS; ECRS, though, would be the best by far. Curiously, then, thort-lived assets, which would receive the greatest shock in the move from the present system to CCRS, would receive relatively little help from ECRS. (These results are based on a five percent inflation rate, which is close to the current rate.)

A judgment call is whether more of the BTT's revenue should be used for replacing some of the proposals in the Administration's tax plan. On the one hand, the Roth program can be defended as innovative and as thoroughly consistent with the goals of tax reform discussed earlier. If more of the BTT's revenues were used for other purposes, desirable parts of this package would have to be scaled back.

On the other hand, many of the Administration's revenue-gaining suggestions have serious defects. Proposals like the "recapture" tax and the elimination of 401(k) plans would intensify anti-saving biases. Ideas like imposing a per country limitation on the foreign tax credit would lead to awesome complexity rather than simplicity. Some suggestions like the elimination of state and local tax deductibility would conflict with the objectives of fiscal federalism; that proposal would also tax individuals on income they do not have. Moreover, many of the disruptive shifts in tax burdens that the Administration's proposals would create (e.g., workers and capital owners in natural resource and manufacturing industries would suffer as effective tax rates rose in those industries) could be avoided if more of the BTT's revenues were used as an alternative to the Administration's proposals. A major concern is that unless this were done, the nation's businesses, which under the Administration's plan would have to cope with numerous shocks and be net losers, would in addition have to deal with the disruptions that would accompany the introduction of the BTT. Although the House Ways and Means Committee is developing some alternative financing ideas, for example, no "recapture" tax but a higher corporate tax and a ferocious minimum tax, early indications are that its suggestions might generate even more problems than would the Administration's. While retaining the BTT's deductibility as a business expense, I believe that the first priority for the BTT's receipts should be to help finance the desirable features in the Administration's plan, most notably its marginal rate reductions, by replacing the many revenue gainers in the plan that would conflict with the tax reform goals of efficiency, fairness, and simplicity. After that were done, I would strongly endorse the options suggested in the Roth program.

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# FINANCING TAX REFORM WITH THE BUSINESS TRANSFER TAX

## Summary

Earlier this year, Senator William Roth (R-Del.) introduced legislation (S. 1102) to establish a so-called business transfer tax (BTT). The BTT would be a five percent levy on each business's value added, where value added is the difference between the value of the business's sales and the value of its purchases from other businesses. As is done with the value added taxes applied in other countries, adjustments would be made in order to tax imports while exempting exports. In the present bill, most of the BTT's revenues would go towards partially replacing the employer share of payroll taxes; about $20 billion yearly would also be available to finance income tax reform. An interesting possibility would be to set the BTT at a higher rate and use the revenues this would generate as a substitute for many of the unappealing revenue gainers now in the Administration's tax overhaul plan. Some of these proposals threaten to defeat the plan, thus blocking the adoption of its most beneficial components: deep reductions in individual and corporate marginal tax rates. Despite some shortcomings, the BTT has a number of desirable properties with respect to efficiency, fairness, and international competitiveness that make it worthy of serious consideration as a partial substitute for either the payroll tax or the Administration's revenue raising proposals. The higher priority use for the BTT might be as a replacement for some of the Administration's suggested revenue gainers, such as the repeal of the ITC and the ACRS, the elimination of the deductibility of state and local taxes, and the numerous industry-specific changes that would greatly increase capital costs in certain sectors of the economy.

The Reagan Administration has put its tax overhaul proposal into a damaging revenue bind. It did this by promising to slash individual and corporate marginal tax rates and double the personal exemption while also vowing that the tax system will

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.

collect as much revenue after the overhaul as it does under current law. To reconcile these promises, the Administration has been forced to propose a large number of massive, controversial, and economically unappealing revenue raisers.[1] The plan's revenue needs are enormous because the highly desirable reductions in individual and corporate marginal tax rates, the doubling of the personal exemption, and the increase in the zero bracket amount will lose about $640 billion in just the five years from 1986 through 1990 according to the Administration's own estimates.

The reductions in marginal rates, which the Administration estimates will cost over $400 billion from 1986 through 1990, are the heart of the tax overhaul plan. With the top corporate rate decreased from 46 to 33 percent, tax angles will play a smaller role in people's economic decisions regarding such matters as whether to consume or invest, whether to buy one product or another, and whether to enter one line of business or another. The reason that the marginal rate reductions will make tax considerations less important in people's decision making is that the reductions will decrease the tax wedge separating underlying economic forces from people's after-tax rewards. For example, an individual in the top income tax bracket is less likely to work fewer hours because of the tax bite if the income tax leaves him with 65 cents of each extra dollar he earns than if it leaves him with only 50 cents.

The challenge is to find revenue gainers that will not undo the beneficial effects of revenue-losing measures like the rate reductions. Unfortunately, the tax increases that the Administration has fashioned to counterbalance these losses have such major and increasingly obvious problems that they have greatly diminished the plan's popular support. A brief review of some of the chief revenue raisers indicates why almost without exception they would make extremely bad tax policy.

**-Eliminate the deductibility of state and local taxes.** Since the federal income tax's inception, taxpayers have been able to claim deductions for their state and local income, property, and sales taxes. In part this reflected the belief that these tax payments diminished people's incomes and so should be deducted from their federal tax bases. It also reflected a federal decision to let state and local tax claims take precedence over federal claims in order to avoid undercutting the tax bases of those lower levels of government. Now the federal government has apparently decided that people's state and local tax payments are part of their incomes after all and so should be included in their tax bases. The Administration's tax plan would repeal the deduction for state and local taxes at the start of 1986. The proposal also suggests that despite the Administration's attempts to shift more programs to lower levels of government, it feels less compelled to avoid preempting state and local revenue sources. The

combined effect of the federal government's cutbacks in state and local grants, its proposed elimination of state and local tax deductibility, and its proposed elimination (elsewhere in the tax plan) of many municipal bonds' tax-free status would severely strain state and local finances. In the category of faint praise, at least this proposal differs from most of the other major ones in the Administration's package by not concentrating on extracting more taxes from the returns to saving and investment.[2]

-**"Recapture" part of previous accelerated depreciation allowances.** Declaring that its proposed tax rate reductions would be a "windfall" to the owners of depreciable property, the Administration advocates slapping a 13 percent tax on a portion of the accelerated depreciation allowances capital investors took between 1980 and mid-1986. In finding this "windfall", the Administration has focused on the plan's main benefit to investors while conveniently ignoring the many ways the plan would hurt them; many investors would, in fact, need a subsidy rather than a new tax to make them whole. The tax calculation itself takes as its benchmark a collection of depreciation schedules that are arbitrary and theoretically unsound. It is especially puzzling that even though the "windfall" argument could be applied to many taxpayers, the Administration has chosen to single out the largest recent contributors to the nation's stock of capital; this is the same Administration that has sought to encourage investment. Besides all this, the "recapture" tax is a retroactive levy that would set a chilling precedent. By increasing the odds of more retroactive taxes in the future, it would put all taxpayers at risk. The tax would reduce future capital formation both because it would create a new source of risk and because it would squeeze many potential investors' cash-flows.[3]

-**Scrap the investment tax credit (ITC) and replace the accelerated cost recovery system (ACRS) with the capital cost recovery system (CCRS).** Although the Administration's tax plan characterizes the ITC and the ACRS as separate matters, they should be considered in tandem because they jointly form the depreciation system that allows investors to recognize for tax purposes their capital asset costs. Indeed in 1981 the Administration regarded the expansion of the ITC and the introduction of the ACRS as central features of its effort to reform the tax system so as to lesson tax disincentives hampering saving and investment. Now the Administration proposes to replace the ACRS with the CCRS and to abolish the ITC entirely. The Administration argues that the CCRS is generous enough when compared to the ACRS, but omits from its analysis the loss of the ITC. In fact, the new depreciation system would increase greatly the after-tax cost of capital investments. The certain outcome is a drop in aggregate capital formation.[4]

Moreover, if recent revisions in the plan are any guide, the Administration and Congress may add new features that will further worsen the tax treatment of saving and investment. In order to pick up extra revenues, for example, the Administration now suggests ending 401(k) plans, flexible and innovative saving vehicles presently used by millions of Americans. It also suggests dropping one of the plan's most positive features: the indexing of business inventories. This marks a further retreat from the Administration's originally bold proposals to avoid taxing as real income the illusionary gains produced by inflation.

The Administration's package would also produce vast shifts in the tax burden. The plan's cuts in corporate and individual marginal tax rates and its increases in the personal exemption and the zero bracket amount would reduce tax revenues an estimated $640 billion over the five years 1986-1990. To finance these revenue losses, the plan calls for various revenue raisers aggregating $272 billion for corporations and $354 billion for individuals. On balance, corporate taxpayers would wind up with a net increase of $118 billion in tax liabilities, and individuals would realize net reductions in their taxes of $132 billion. By any measure, these are massive shifts in taxes, not only among individual taxpayers but as between individual and corporate taxpayers and among corporations, as well.

The Administration's ultimate defense of these and other questionable tax hikes is that its plan needs the revenues. One reaction to this defense is to wonder whether the plan's desirable features manage to outweigh the inefficiencies, inequities, and complexities inherent in the current line-up of revenue raisers. A more positive reaction is to ask whether the plan could collect the revenues it needs to finance these desirable features by adopting other, less destructive revenue gainers. The objective is to find a tax that can be collected at the business level, does not discriminate against saving, is fair, is reasonably simple, and has a large revenue potential.

Earlier this year, Senator William Roth (R-Del.) put before Congress a bill (S.1102) that with some modifications would meet all of these criteria.[5] In addition, it would improve the international competitiveness of U.S. producers in world markets by lessening the tax handicaps under which they now operate. The proposed levy, which the senator calls a business transfer tax (BTT), is a tax on the value that businesses add to their products during production. In its present form, most of the tax's revenue would be used to lower businesses's payroll tax liabilities with some receipts left over to finance income tax reforms such as reducing individual and corporate marginal tax rates.[6]

The bill could be modified to finance many of the constructive, revenue-losing features of the Administration's tax plan either by raising its rate or by reducing its payroll tax offset. Of course, an informed judgment regarding the BTT's merits requires an examination of its main features and an analysis of its economic properties. Along the way, one should also consider what would be gained and what lost by modifying it from its present form into a replacement for many of the Administration's suggested revenue raisers.

Certainly, the BTT may create problems of its own. Perhaps the greatest danger is that it would give the government a new tax with an enormous revenue potential that could be used to finance a further rise in federal spending relative to national output. Another serious concern is that the BTT, like the revenue raisers now in the Administration's plan, would produce large shifts in tax liabilities throughout the economy, with millions of taxpayers winning and other millions losing. Many of these shifts would be unfair and disruptive. State and local governments might also object to the BTT if they saw it as a competitor to their sales taxes. Two frequently mentioned fears (shown in later sections to have little economic support) are that the BTT might be regressive and inflationary.

**The BTT's Main Features**

The BTT would be collected at the business level. A business would calculate its tax liability by finding the difference between its "business receipts" and "business expenses" and then multiplying this difference by the five percent tax rate. For example, if a business has receipts and expenses for tax purposes of $40,000 and $15,000, respectively, its transfer tax would be $1,250, which is five percent of the $25,000 difference.

In general, the BTT defines business receipts according to the rules developed by the income tax code in order to minimize the additional compliance costs placed upon taxpayers. In several important respects, though, the BTT defines receipts more narrowly than does the income tax. It does not include revenues from dividends, interest, or gains on the sale of capital assets (e.g., stocks and bonds) "not used in the active conduct of a business by the taxpayer." Further, the BTT exempts the value added to several categories of products at the retail level: food sold for off-premises consumption, medical care, the sale or rental of housing, and the sale or rental of land. It also exempts charities (except for receipts from unrelated businesses of such organizations) and governments.

Whereas the BTT bears some resemblance to an income tax in how it defines business receipts, it differs dramatically from an income tax with respect to its definition of deductible expenses. Under the BTT, this deduction is not intended to cover all varieties of business costs but only the costs of goods and services obtained

from other businesses. The purpose of this deduction is to remove from each business's tax base the amount that has already been taxed at previous stages of the production process.

For a brief illustration of the tax's computation, suppose a small firm receives $40,000 from sales and $5,000 in dividends from the stock it owns in another company. Also suppose that it makes $15,000 in purchases from other firms for inputs like equipment, utilities, insurance, and data processing. Under the transfer tax, the firm's liability would be $1,250, which is five percent of the $25,000 difference between its business receipts (which, remember, exclude dividends) and its purchases from other firms.

Special rules would apply to exports and imports. The revenues a firm derives from exporting goods and services would not be subject to the BTT; if a business imports, however, it would have to pay the transfer tax on the value of those imports. In effect, these rules remove a business's exports from its tax base while adding in the value of its imports.

In the event that deductible expenses exceed receipts, especially likely for start-up firms and exporters, the excess deductions could not be used to claim a tax refund. However, they could be carried forward for up to fifteen years as a deduction against future business receipts.

A novel feature of the BTT is that taxpayers could claim all of it, except for the portion attributable to imports, as a credit against their employer share of payroll taxes. For instance, imagine that an employer has payroll tax obligations of $1,500 and transfer tax liabilities of $1,250. According to the bill now before Congress, the business could reduce its payroll tax liability to $250 by claiming a $1,250 credit for its transfer tax payments.[7]

At present, businesses can claim the employer share of social security taxes as a deductible expense for income tax purposes. To maintain this benefit, businesses would be allowed to claim as income tax deductions both the BTT payments they credit against their payroll taxes and the excess, if any, of their payroll taxes over the BTT credit. In the example, the firm could deduct from its income tax base both its $250 in FICA payments remaining after the credit and its $1,250 in transfer taxes. To avoid depleting the social security trust fund, transfer taxes used to offset payroll taxes would be credited to the social security trust fund.

Because of the credit, the BTT would not increase the total tax liability arising from the domestic production of most goods and services: the fall in the payroll tax would counterbalance the rise in the transfer tax. The major exception would be capital

intensive domestic producers (e.g., chemical plants, utilities) with a low level of payroll relative to their value added: capital intensive firms might not have enough payroll taxes to offset their transfer taxes. Imports, ineligible for the FICA credit, would carry the main share of the net tax burden. The five percent transfer tax is estimated to raise $20 billion yearly net of the FICA credit, of which $17 billion would come from imports and $3 billion from domestic producers whose transfer tax liabilities would exceed their payroll tax liabilities.[8]

**The BTT As A Levy On Value Added**

For people thinking in terms of income taxation, a natural question about the BTT is why it would limit the business expense deduction to purchases from other firms. If the tax base were income, expenses like wages and interest payments should also be allowed as deductions. The explanation is that the BTT is not an income tax but a tax on value added. A business's value added is the difference between the value of its output and the value of its input purchases from other businesses. This difference is the tax base for the transfer tax. The base is calculated by having businesses add up their gross receipts and then subtract out their purchases from other businesses.

The concept of value added can be illustrated with a short numerical example. Suppose that a manufacturer produces an intermediate product which it sells to a retailer for $5,000. Also assume that in the process the manufacturer bought $800 of raw materials and $1,200 of capital goods from firms antecedent to it in the production chain. Further, suppose that after adding its own services, the retailer resells the output to consumers for $7,500. In this example the manufacturer bought inputs to which other firms had already added $2,000 of value. The manufacturer's own value added is the $3,000 spread between the price of its output and the cost of the inputs it purchases from other firms. The retailer then adds another $2,500 ($7,500 - $5,000) to the product's value.

The cumulative value added to the product by the various businesses along the production chain has economic significance: it equals the product's final price to consumers ($7,500 = $2,000 + $3,000 + $2,500). Because of this equivalence between total value added and final sales price, consumer expenditures can be measured in two basic ways at the business level. Each of these approaches to measuring consumption expenditures can be used, in turn, to construct a consumption-based tax.

One option is to concentrate on sales to consumers, recording the cumulative amount of these sales. In the example this method would focus on the $7,500 sale made by the retailer. A levy imposed on this sale and, more generally, on all sales to

consumers of goods and services, would have consumption expenditures as its tax base. This is the route chosen by the familiar retail sales tax although, in truth, most actual retail sales taxes are limited in their scope, exempting some goods and many services.

An equally accurate method of measuring consumer expenditures is to cumulate the value added throughout the production process. A tax based on this approach would be assessed on each business along the production chain according to the value it has added. A tax that does this is known as a consumption-type value added tax. Value added taxes (VATs) are now found in many countries; they are especially common in Europe. This is the category to which the BTT belongs although it would differ in several important respects from the VATs currently operating in Europe.

In contrast to these approaches, which center on the business sector, consumption expenditures can alternatively be measured at the household level. Households would accomplish this by calculating the difference between their incomes and their nonconsumption expenditures. This can be translated into a tax base by having individuals find their incomes and then subtract out their saving, taxes, and other nonconsumption outlays. This sort of tax is known as a consumed income tax.

If consumption is measured by the value added method, care must be taken to count each business's value added only once. In the numerical example, suppose each firm were taxed on its total sales with no allowance made for purchases from other firms. Then the firms making sales to the manufacturer would be taxed on $2,000 (and the firms selling to these supplies would also have been taxed on their sales), the manufacturer's tax base would be $5,000, and the retailer's would be $7,500. As a result of this multiple counting of value added, the total tax base would be at least $14,500, which is almost twice the true amount of value added.[9]

An overestimate of value added also occurs if capital goods purchases cannot be written off fully and immediately (i.e., expensed). In the example the manufacturer bought $1,200 of capital goods. If these could not be written off at all, the manufacturer's tax base would be $4,200 because the base would include investment spending on top of value added. If capital goods could be written off only gradually, as must be done under the current tax system, the tax base would also be overstated in present value terms because it would include value added plus some portion of investment spending.[10]

A consumption-type VAT can measure value added in several ways. The measurement technique chosen may have a strong influence on the tax's appearance, the information it requires, the paperwork it generates, and its ability to deal with some special

situations. These differing characteristics may recommend one computational method over another. However, these techniques share the common property that all of them measure value added. It is helpful to keep this similarity in mind so as to avoid exaggerating the importance of the measurement technique. Because many of a tax's economic properties depend upon the tax base rather than upon the calculation technique, the BTT's properties in areas like efficiency, equity, and international competitiveness would be much the same regardless of the computational method used by it in determining value added.

The BTT takes the most direct path (and the one used in the illustration) by finding the difference between gross receipts and inter-firm purchases. An advantage of this subtraction approach is that almost all of the needed information is already available from income tax and internal bookkeeping records. It is the technique that bears the closest resemblance to those used in calculating income taxes. Accordingly, large segments of the tax calculation would be familiar, moderating the administrative costs that the levy would impose on taxpayers.

The use of the subtraction technique explains a feature of the BTT that at first glance might seem puzzling: the tax does not count receipts of interest and dividends in its definition of business receipts. The reason for this is that these items have already been taxed in the hands of the business paying them. To understand this point, consider the manufacturer in the example. The manufacturer adds $3,000 of value and uses that amount to pay various forms of compensation, of which the principal ones are wages to its workers, interest to its lenders, and, with what is left over after other claims against the manufacturer, dividends to its equity holders. Because the producer is taxed on this $3,000 of value added, those who receive that value added in the forms of wages, interest, dividends, and other compensation should not also be taxed on it. To avoid the error of counting both the value added and the claims made on that value added, receipts of interest, dividends, and wages are correctly excluded from the BTT.

The subtraction technique chosen by the BTT is not the only method by which value added could be determined. If it were so desired, the BTT could use other computational techniques. As outlined above, a business's value added could alternatively be measured by adding up the various claims made on it. This is known as the addition technique. For the manufacturer, the $3,000 of value added could be found by summing the amounts directed into wages, interest, and dividends. Although this approach is slightly more roundabout than the subtraction technique, businesses already have available most of the necessary information. The only VAT now existing in the United States, Michigan's single business tax, utilizes this technique.

A third option is the invoice-credit technique, which is a modification of the subtraction technique and is widely used in Europe and elsewhere. Instead of deducting purchases from other businesses, a taxpayer receives invoices with its purchases that show the taxes already paid on those inputs. The taxpayer computes a tentative liability based on its gross receipts but then deducts from that the tax payments indicated on the invoices it receives. The main advantage of this technique is that the invoices create records which increase the difficulty of tax evasion. The primary disadvantages of this technique are that it entails more paperwork than the subtraction method and may appear more novel to taxpayers. Because this is the most common method of computing the tax, some individuals associate the term "VAT" with this particular procedure.

An important feature of the proposed tax is that it would be assessed on imports but not exports. Are these so-called border tax adjustments consistent with the value added framework? In fact, they are acceptable (as will be explained later) and indeed common.

In two respects, however, the BTT deliberately departs from a pure value added framework. One concerns what happens when the cost of a business's inputs exceeds the value of its sales. Although the value added format would seem to entitle the business to a refund, the BTT would merely allow the business to carry forward to future years the amount by which expenses exceed receipts. Even if the firm eventually gets to claim the expenses, the delay will have reduced their present value. Start-up firms would be especially likely to suffer because of the delay this procedure entails. Another departure from the value added framework is that producers of certain products would be exempt from the tax. For instance, a grocery store would not have to collect the transfer tax on the food it sells to households. More will be said in a later section about the tax's selective exemptions.

**The Saving-Consumption Trade-Off**

One of the major disadvantages of an income tax is that it weighs more heavily on saving than on consumption. Because an income tax twists incentives in this manner, it discourages people from saving and investing, thereby slowing advances in productivity, output, and living standards. The current system's double income tax -- individuals' investments in corporate equity are taxed at the corporate level and again at the personal level -- magnifies the bias. In contrast, one of the primary attractions of a consumption-based tax is that it is free of this problem.

To illustrate how income and consumption taxes differ in this regard, suppose an individual is trying to decide whether to consume or save $2,000 of his income. Also suppose that in the

absence of taxes these earnings can be invested to yield a $200 annual stream of future income (this assumes a 10 percent rate of return). For expositional simplicity, assume that the individual converts this income stream into future consumption. In this case, then, each dollar of foregone current consumption produces a $0.10 annual stream of future consumption.

Now suppose the government imposes a five percent income tax and that, initially, the before-tax rate of return remains ten percent. As a result of the tax, $2,000 of before-tax earnings drops to $1,900 of after-tax earnings. The individual can use these earnings to purchase immediately $1,900 of consumption goods and services. If the person instead saves the $1,900, it will yield an annual income flow of $190 before tax and $180.50 after tax. Comparing the after-tax options, which are $1,900 of current consumption versus $180.50 of yearly future consumption, the individual would find that each dollar of saving would now produce only $0.08 of yearly future consumption. Thus the income tax has lowered the relative reward for saving by 20 percent.

In an important respect, this example actually understates the bias because it assumes that the government imposes only a single income tax. In fact, under the current tax system, individuals face taxation at both the corporate and personal levels on their equity investments. Each of these income taxes exerts an anti-saving bias, thereby intensifying the total effect.

Suppose that instead of employing an income tax, the government levies a 5 percent VAT on producers' net receipts. The individual can now buy immediately $2,000 of consumption goods and services gross-of-tax and $1,900 net-of-tax. (The $100 difference is the five percent tax on the $2,000 of cumulative net business receipts.) If the individual instead saves the $2,000 of earnings, it would not be taxed immediately. It would yield an annual before-tax income flow of $200, which would permit yearly net-of-tax consumption expenditures of $190. Unlike the income tax, the consumption tax continues to let the individual exchange one dollar of current consumption for a $0.10 annual flow of future consumption. Therefore, it accords equal treatment to saving and consumption.

In the bill now before Congress, most of the revenues from the BTT would be used to lessen payroll taxes. Whether this substitution would reduce the tax system's pro-consumption bias would thus depend largely on whether the payroll tax encourages consumption at the expense of saving. As it turns out, the payroll tax is relatively neutral in this respect because it does not produce the repeated taxation of saving that is characteristic of an income tax. Most economists believe that the employer's share of the payroll tax is passed back to workers. Thus the payroll tax reduces people's after-tax labor incomes, hence exerts a bias against work and in favor of leisure

and other nontaxable activities. Thereafter, however, that income is free of further payroll taxes whether the individual decides to spend or save it. Accordingly the tax treats consumption and saving evenhandedly.

Because most of the transfer tax would go towards replacing a relatively neutral tax, the bill now before Congress would do little to correct the tax system's anti-saving bias.

**Is The BTT Fair?**

Taxes are frequently measured against two standards of equity. One is horizontal equity, which means that if two people have the same level of economic welfare before paying taxes, they should continue to be on a par after paying taxes. The other standard is known as vertical equity. This even more subjective standard means that if two people have different levels of economic welfare before the imposition of a tax, the one with the greater welfare should pay a disproportionately greater tax. There is virtually no agreement on the proper degree of adjustment.

A broad-based VAT does extremely well in terms of horizontal equity. Suppose, for example, that before the imposition of a tax two individuals are identical except that one wants to consume heavily while the other prefers saving. Whereas an income tax would weigh more heavily on the saver, a VAT preserves the individuals' before-tax equality because it lowers the rewards for both consumption and saving in the same proportion. In short, a VAT does not give an artificial advantage to either consumption or saving. Of course, if measured against the anti-saving biased income tax system, a VAT might seem to help savers.

The issue of whether VATs are indeed neutral between consumption and saving frequently spills over into the realm of vertical equity because there is a widespread perception that the poor consume relatively more of their income than do the rich. Those who think VATs discriminate against consumers tend also to believe that they discriminate against the poor. This argument has at least two flaws, however. First, the relation upon which the argument depends, that saving is an increasing function of income, is much weaker in the long run than it seems on a year-to-year basis. Because people tend to stabilize their living standards by consuming relatively more in lean years and saving relatively more in good years, the positive relationship between income and the saving rate is strong in the short run. In the long run, though, the relationship becomes far weaker.

Second, whether or not income and the saving rate are positively correlated, a VAT is innocent of the charge that it treats consumption more harshly than saving. As shown earlier, a VAT does not change the relative rewards of consumption and saving. Thus even if the poor have a higher consumption rate than the rich, a VAT would put both groups on the same footing.

It is true that a broad-based, flat-rate VAT would be less progressive than the current income tax system. But unless one believes that people pay no attention to the tax climate, this does not mean that a proportional VAT would make the poor worse off than would a progressive, equi-revenue income tax. By avoiding an income tax's anti-saving bias, a VAT is more conducive to capital formation and productivity gains. This is very important to the poor because historically they have often been those most helped by more rapid economic growth. Thus a tax which seems from a static perspective to be less generous to the poor may in reality be the tax that aids them more. This point may help to explain why many socialist governments in Europe that with their heavy labor representation ought to oppose regressive taxes have been in the forefront of adopting VATs.

There is an even more fundamental reason for doubting that a broad-based VAT would be regressive. It hinges on the question of whether consumers bear the tax in the form of higher prices or whether people selling labor and capital services bear the tax in the form of lower after-tax returns. As explained in a later section, a VAT will probably be shifted back to the workers and investors involved in the production process, thereby reducing their after-tax incomes, rather than being shifted forward to consumers. Suppose as a rough approximation that a VAT is borne by the recipients of labor and capital income in the same proportions as their respective contributions to value added. Far from being a regressive levy, a VAT will then be a proportional tax on labor and capital income.

Nevertheless, to deflect charges of regressivity, the bill now before Congress would partially exempt food, housing, land, and medical care from the new tax. Superficially, these steps appear to protect the poor because they remove several categories of necessities from the tax base. Although these exemptions make excellent political sense, the economic support for them is weak. Their value to the poor rests on two questionable assumptions. First, it must be assumed that the poor devote a larger fraction of their resources to buying exempt products than do the rich. The trouble with this assumption is that people frequently upgrade the quality and quantity of "necessities" like housing in step with their wealth. Thus the exemptions may fail to lighten the tax load on the poor relative to the loads on other income groups. At the least, the exemptions are poorly targeted.

Second, the logic behind the exemptions implicity assumes that the tax is passed forward to consumers rather than backward to producers. As discussed more fully in a later section, however, backward shifting is more likely. If the tax is passed backward, it will be people like grocers, doctors, and landlords, that is, the suppliers of exempt items, who reap most of the benefits from the exemptions. With backward shifting, consumers would gain little from the exemptions because they would not be paying the

tax on the exempt items in any case. Besides failing to help the poor, the exemption would violate the criterion of horizontal equity because it would favor people in some occupations over otherwise identical people in different occupations.

Another problem with exemptions is that they create a tax inefficiency. By putting less of a tax load on some items than on others, they encourage the overconsumption and overproduction of the favored goods and services. Suppose, for instance, that a business adjusts the production of outputs A and B until they yield the same return in the absence of tax considerations. If the government suddenly imposes a tax on A while exempting B, the business will shift its output mix towards B solely in response to the tax.

It should be added that the exemptions are less sweeping than they might seem because they would apply only at the retail level. For example, a grocery would not have to pay the transfer tax on its food sales, but producers at earlier stages would have to pay tax on the value they added to the food. As a result, only the value added to the food at the retail level would receive the exemption.

In the current proposal, most of the revenues from the BTT would go towards offsetting the employer share of the payroll tax. With its broad base, flat rate (up to the wage ceiling), and neutrality between consumption and saving, the payroll tax turns out to be a slightly regressive levy but one that has provoked far less criticism on equity grounds than, for example, the income tax. Hence, the use of the BTT to reduce the payroll tax should have only a small effect on tax equity. A side effect of the proposed offset is that the significance of the special exemptions would be further diminished. In large measure, the producers of exempt items would merely find themselves paying less BTT but more payroll tax than the producers of nonexempt items.

**Simplicity**

A broad-based, flat-rate VAT computed by the subtraction technique is a simple tax conceptually and operationally. Most businesses could simply turn to their income tax and internal-use records to ascertain their gross business receipts and their purchases from other firms. Businesses would find, for example, that business receipts under such a tax differed in only a few, easily calculated respects from gross income under the income tax. The desire to keep the BTT relatively simple accounts for the decision to use the subtraction technique rather than the more common invoice credit technique. The proposed tax also merits praise for having adopted a single-rate format. This should furnish taxpayers large administrative saving with respect to their tax calculations and bookkeeping. The recommendation

for a single rate is all the more welcome because the majority of nations with VATs have chosen complicated, multiple-rate formats that substantially increase their taxes' administrative costs.

Most of the complications found in the BTT arise from its special exemptions and border adjustments. For instance, a firm that sold some exempt items and some nonexempt ones would have to distinguish between the categories in its records and its tax calculations. Given that the exemptions would usually apply only at the retail level, businesses with both retail and nonretail operations, like many grocery chains, would confront especially complicated problems regarding how much of their value added was really exempt. To make the required distinctions, the government would assuredly need to issue complex regulations, and businesses would probably need to keep extensive records and perform tedious calculations. In addition, businesses with both exempt and taxable sales would have to allocate their expenses between the categories (they could only claim expenses against the taxable sales) according to a simple but arbitrary formula. Turning from receipts to deductions, businesses that buy exempt items would not be allowed to claim many of those items as deductible expenses. Accordingly, they would have to distinguish between deductible and nondeductible purchases from other firms.

In the bill's current form, all BTT payments except those on imports could be credited against the employer share of payroll tax liabilities. Because the BTT would not actually replace the payroll tax, though, taxpayers would face all the old tax forms plus some new ones. Further, businesses would need to adjust their payroll tax payments to reflect their transfer tax credits. Fortunately, the required adjustments would be straightforward.

**Taxing Exports And Imports**

The BTT would make three adjustments with respect to exports and imports. One is that businesses would not have to include export sales in their business receipts. They could, however, continue to deduct their purchases from other businesses. Another is that importers would have to pay the five percent tax on the full value of their imports. A third provision would bar the transfer taxes paid on imports from being credited against payroll tax liabilities.

The first two provisions have the effect of restricting the transfer tax to goods and services that are consumed domestically. To this end, exports are excluded from the tax base because unless later imported they will be unavailable for domestic consumption. Meanwhile, imports are added in full to the tax base because unless later exported they will be available for domestic consumption.

The underlying issue is whether a government wishes to assess its tax according to whether products are consumed domestically or whether they are produced domestically. If a government chooses the former policy, imports should be taxed on the value added to them abroad while exports should not be taxed. This is what the first two border adjustments accomplish. In the absence of such border adjustments, a VAT would tax the value added in domestic production regardless of where consumption occurs. International considerations tip the scale in favor of the border adjustments. Most nations with VATs, including several of our major trading partners, gear their VATs to domestic consumption by exempting exports while taxing imports. This is sometimes called the country-of-destination principle. If a U.S. VAT failed to make similar adjustments, U.S. products would encounter tax handicaps at home and abroad. For example, in the absence of border adjustments, American products exported to, say, France would be saddled with both the U.S. and French VATs while French products sold in France would bear only the French VAT. With the border adjustments, in contrast, U.S. exports to France would bear the French VAT, as would their foreign competition; French exports to the U.S. would bear the American VAT, as would their domestic competition.

The border adjustments would work against simplicity because businesses would have to keep separate records of imports and exports in order to treat them properly for tax purposes. A firm that exports some of its products, for example, would have to keep track of those sales in order to avoid including them in its tax base.

Because the BTT would calculate value added by the subtraction technique while most foreign VATs use the invoice credit method, the mechanics of the transfer tax's border adjustments would differ slightly from those found elsewhere. These technical differences in themselves are no problem. What does warrant concern is that because the transfer tax is nonrefundable (though it can be carried forward), its export rebate may be incomplete, thereby failing to relieve American exports of the U.S. VAT.

Suppose, for example, that an exporter buys $10,000 of inputs from other firms and, with the addition of its own inputs, produces a product that it sells abroad for $15,000. According to the rules of the BTT, the exporter would not have to include the $15,000 sale in its tax base and could deduct its $10,000 of purchases from other firms. At a five percent tax rate, these adjustments would seem to qualify the business for a $500 rebate. This rebate is important because without it the export would continue to bear the $500 of transfer taxes assessed on it during earlier production stages. The problem is that because the transfer tax is not refundable, the exporter could only recover the full $500 if it has at least $500 of BTT liabilities arising from taxable domestic operations. The unused portion of the $500 could be carried forward to future years, but in present value

terms the value of the refund would decline rapidly. For the many firms that concentrate on exports, this restriction would prevent the border adjustments on their exports from being complete.

The U.S. income tax system lacks border adjustments. As a result, U.S. exports must often shoulder both the U.S. income tax and foreign VATs. In contrast, imports into the United States are often relieved of their foreign VATs and may largely avoid the U.S. income tax as well. These uneven rules place American firms at a disadvantage relative to their foreign competitors. Although it would be possible in terms of mechanics to equip income taxes with border adjustments, doing so would create serious legal problems. The United States is a signatory to an important international agreement, the General Agreement on Tariffs and Trade (GATT), that bars "direct" taxes like income taxes from containing border adjustments but allows "indirect" taxes like VATs to have them. In order to improve the international competitiveness of U.S. firms while abiding by GATT, a number of economists have advocated replacing the corporate income tax with a VAT.

Instead of replacing the corporate income tax, though, the proposed tax would serve to offset a large part of employers' payroll tax liabilities. The payroll tax is like income taxes in that it does not make border adjustments. On exports, for instance, a government does not rebate the payroll taxes that businesses incurred during the products' production. Therefore, the partial replacement of the payroll tax by a levy with border adjustments would improve the competitive position of U.S. producers.

The BTT's role as a partial replacement for the payroll tax explains the rationale for a third tax rule with respect to international trade: the transfer tax assessed on the value of imports cannot be credited against payroll tax liabilities. Imports themselves have incurred no U.S. payroll taxes to be offset; accordingly, it is reasonable for the U.S. government to require that the reduction in the U.S. payroll tax be of no benefit to imported products. The aim of the third border adjustment rule is to guarantee that businesses cannot take the transfer taxes they pay on imports and use them to offset the payroll taxes they owe on their domestic operations.[11]

In one case, though, the BTT would provide imports with a tax advantage denied to domestic production. Suppose that a U.S. business, for instance, a manufacturer, were to buy $2,000 of inputs from abroad, paying $100 in transfer taxes on the value of those imports. Regardless of whether the $2,000 of inputs were produced domestically or abroad, the BTT would allow the manufacturer to subtract them from its sales in determining its value added and the amount of transfer tax due on that value

added. So far, this tax treatment is even-handed. In addition, however, the BTT in its current form would also let the manufacturer deduct as business expenses the $100 of transfer taxes that it paid on its imported inputs but would deny a comparable deduction for transfer taxes paid on domestic inputs. That is, if the manufacturer instead bought $2,000 of domestically produced inputs on which its suppliers had paid $100 of transfer taxes, neither the manufacturer nor its suppliers could claim those $100 as business expense deductions. This difference in tax treatment favors imported over domestic inputs.

**Effect On The Price Level**

A frequently expressed concern with regard to the adoption of a VAT is that it might push up prices. The fear is that if an item costs, say, $100 before the establishment of a 5% VAT, it will cost $105 after the tax's imposition and that similar price increases will occur for other goods and services. This scenario contains the implicit assumption that producers can shift the tax forward to consumers. If one takes another step and contends that the tax would cause a continuing chain of price increases, not just a one-time boost, the tax would stand accused of contributing to the general, long-run upward movement in prices that we call inflation.

However, these accusations are difficult to support because it is doubtful that producers can successfully pass the VAT forward to consumers. Producers would encounter the stumbling block that there is a balance between the economy's supply of goods and services and the amount of money being spent to buy that output. If the economy is in a position where the current level of money spending is just sufficient to buy the current level of output, producers could only raise their prices if either they were willing to sell less or they could persuade buyers to increase their money spending for consumption goods and services.

It is far from obvious that the introduction of a VAT would convince consumers to pay more for the same amount of goods and services, abandoning their old level of money spending on consumption for a higher one even though their incomes have not increased. Admittedly, if the Federal Reserve decided to accompany the tax with a monetary expansion, money spending would rise, but the cause would be money growth not the tax change. In the absence of a rise in money spending, producers would discover that if they raised their prices, they could no longer sell all of their output because there would be too little money spending to buy it: buying the old output at the new prices would require more money spending than was previously sufficient. The unsold output and the consequent idling of resources would put intense pressure on producers to reverse their price increases. As a result, although producers would be desirous of passing the tax forward, they would probably be unsuccessful; the tax would tend to be passed back to them and to the owners of the resources they employ.

Notice that the key to this analysis is the relationship between output and money spending. Therefore, the argument is not specific to a VAT but can be applied to taxes in general whether they happen to be based on consumption, income, wealth, or some other variable. With respect to VATs, the analysis does not depend on the technical method by which the VAT is calculated. It is equally valid whether the tax employs the addition, subtraction, or invoice credit computation technique.

The tax base does affect the outcome in one way, though. An efficient tax will tend to permit higher productivity and more output than an inefficient tax. Thus, if an efficient tax were to replace an inefficient one, the substitution would tend to boost real output. The gain in output, in turn, would tend to exert downward pressure on prices. For example, if a VAT (computed by any of the main techniques) were to replace the corporate income tax, the positive supply response would tend to lower prices.

**Revenue Potential**

Broad-based taxes can collect an enormous amount even at relatively low rates. Estimates prepared for Sen. Roth's office provide a glimpse of the BTT's power in this respect.[12] First, however, the estimates should be prefaced with a warning. They were constructed under the unrealistic assumption that people do not change their behavior in response to the tax system. While this simplifies the estimation procedure, it ignores important feedback effects, meaning that the forecast results are unlikely ever to be realized.

It is estimated that in 1986 the BTT would have a tax base of approximately $1,500 billion with about $1,160 billion of this coming from domestic production and about $330 billion from imports. Thus in 1986, each percentage point of tax would bring in gross receipts of $15 billion ($11.6 billion and $3.3 billion from domestic production and imports, respectively). The 5 percent tax introduced before Congress would bring in gross receipts of about $75 billion ($58 billion and $17 billion from domestic production and from imports). However, the payroll tax credit would reduce net receipts to about one-fourth of the gross, roughly $20 billion ($3 billion and $17 billion from domestic production and imports).

For another perspective, consider the revenue needs of the Administration's plan in 1990 when all of its major provisions would have been phased in. The plan's big revenue losers, the reductions in marginal tax rates and the doubling of the personal exemption, would lose approximately $160 billion in that year. The BTT would require a rate on the order of 8.5 percent to collect about that amount in gross receipts in 1990 (about $125 billion from domestic production and about $35 billion from

imports). If the payroll tax credit is retained, of course, an 8.5 percent BTT would collect much less on a net basis. With the credit, it would take a tax rate of about 13.5 percent to gather $160 billion in net receipts in 1990.

These figures indicate that the BTT has the ability to counterbalance all the revenue losers in the Administration's tax plan. Of course, it should not be thought that the BTT would have to replace all of the Administration's suggested revenue gainers. If some of them are judged desirable, they could be retained and the BTT could be set at a correspondingly lower rate. This approach has the advantage of replacing revenue raising considerations with considerations about the intrinsic rightness or wrongness of the present law provisions that the Administration proposes to modify. In terms of its revenue potential, then, the BTT is a viable alternative to a series of bad proposals, including the elimination of the state and local tax deduction, the repeal of the ACRS and the ITC, and the new depreciation "recapture" tax.

Unfortunately, the revenue potential of a broad-based tax like the BTT also presents dangers. Once introduced into the tax system on a revenue neutral basis, it could, with its immense revenue gathering ability, later become a device for expanding tax collections and government spending. In the context of the BTT, this might be done by enacting it at one rate and sometime thereafter raising the rate. If the transfer tax initially contains the FICA credit, more revenues could be brought in later by scaling back the credit. If the BTT is used in place of the revenue gainers now in the Administration's tax plan and if the plan is enacted, the government might subsequently try collecting more taxes by asking again for measures like the repeal of the ITC.

These dangers make it imperative that the BTT not be enacted without an extensive public debate that emphasizes it is not to be used as a means for increasing total tax collections. Indeed, Sen. Roth was sufficiently concerned about the possible misuse of the BTT's net receipts that he made the last section of his bill a sense of the Senate resolution "concerning use of BTT revenues". The resolution states that the BTT's net revenues should be used as a means of funding income tax reform, not as a device for increasing aggregate government revenues. A complementary option might be to include in the bill a provision to limit the rate at which the BTT could be imposed, at least for the next several years.

**Shifts In Tax Burdens**

One of the most persuasive arguments made against major tax changes is that they almost inescapably entail some unpleasant economic disruptions and arbitrarily create winners and losers

throughout the economy. This criticism is frequently made of VATs and other consumption taxes. It is, therefore, of interest to examine the shifts that the BTT would produce. To make the examination relevant, it should also be specified what role the BTT would be expected to play in the tax system.

In its currently proposed form, the BTT would be assessed at a five percent rate and have a payroll tax offset. The biggest losers by far would be importers: they would have to pay the five percent tax but would be denied the rebate. Estimates released by Senator Roth's office suggest they would incur about 85 percent of the net tax burden. Some of this would probably be passed along to domestic firms that have inflexible demands for foreign products, such as many chemical firms and clothing stores. These businesses, then, would also tend to be losers.

Firms whose products have a high domestically produced content would tend to gain. In general, their tax liabilities would not rise because their BTT payments could be credited against their payroll taxes. Further, they would be in a stronger competitive position against imports. An important exception would be firms with a low ratio of payroll to value added. Such firms might experience a net increase in their total tax liabilities because they might not be able to take full advantage of the payroll tax credit. Capital intensive firms would be particularly likely to fall within this category.

If, under this proposal, the BTT's revenues net of the FICA credit were returned to taxpayers in the form of, say, marginal rate reductions, the gains would be widely diffused throughout the economy with each separate taxpayer tending to notice a small benefit.

Another option worth investigating is using the BTT as an alternative to some of the suggested tax hikes in the Administration's tax plan. This is an interesting comparison because both courses of actions would lead to massive shifts in tax burdens. That is, the BTT would not be compared to an alternative involving no tax shifts but to one producing very large, but different, shifts.

The Administration's proposals would, on the whole, tend to tax capital income far more heavily than does current law, but the changes would be uneven across industries. Capital intensive firms, for instance, would tend to be badly hurt by the replacement of the ITC and the ACRS with the CCRS. Meanwhile, some service industries with low amounts of capital would be big winners because of the marginal rate reductions.

To use the BTT as a major revenue raiser in its tax plan, the Administration would need to raise its rate. The payroll tax offset might either be retained or dropped; retaining it would

One response to this objection is to note that the federal government has employed excise taxes throughout its history. In fact until World War I, excises and customes duties accounted for over half of all federal revenues. The federal government still collects about five percent of its revenues from a wide range of excises. To be sure, the federal government has not previously enacted a broad-based sales tax, but it is clear that the federal government has not reserved sales taxes for the exclusive use of other levels of government either.

Another response to possible state and local objections is to assess how much effect the BTT would actually have on state and local revenue sources. As currently proposed, the BTT would leave the overall tax liabilities of many businesses almost unchanged; the chief impact would be reserved for imports. Further, the net amount raised by the BTT would only be about half as much as is now raised by federal excises. Admittedly, state and local governments might fear that the BTT would put more pressure on their revenue sources later (i.e., that the tax would be enacted at a moderate rate but be increased shortly thereafter).

State and local governments might view the BTT differently if it were used to replace some of the revenue raisers now in the Administration's tax plan. The provision that most concerns these lower levels of government is the proposed repeal of the federal income tax deduction for state and local taxes. Given the immense pressure that repeal would put on their finances, it is possible that state and local governments would view the BTT as the lesser of the evils and drop or at least muffle their usual objections to it.

**Pros And Cons Of The Payroll Tax Credit**

In the bill now before Congress, most of the transfer tax's revenue would go towards offsetting payroll taxes. Approximately $20 billion a year would be left over and could be used for income tax reform (e.g., reducing marginal tax rates). If not for the payroll tax offset, the five percent transfer tax could finance a far larger amount of income tax reform. Correspondingly, if the BTT were made the main revenue raiser within the Administration's tax plan, the tax could be set at a much lower rate if it dropped the payroll tax offset than if it retained the offset. Because of this tension between the payroll tax credit and the tax rate, a natural question is whether the credit justifies itself in comparison to the transfer tax's other potential uses.

In assessing the payroll tax's weaknesses, a good place to start is equity. The payroll tax is frequently criticized for being regressive. People with labor incomes below the wage ceiling pay a larger fraction of their incomes in payroll taxes than do

keep somewhat more of the net tax burden on imports. Either way, though, the border adjustments would tend to relieve exports of the tax while taking away from imports a tax advantage that they now enjoy.

Suppose, as argued earlier, that the BTT is shifted back to the workers and investors involved in the production process. The BTT would then have a relatively uniform effect on all income derived from the production process. In contrast to an income tax, it would not emphasize the taxation of capital income. This would tend to benefit capital intensive firms. Under the BTT they could expense their capital costs; under the Administration's proposals, they would be forced not only to depreciate their capital costs but to use even more restrictive cost recovery rules than are now available.

Labor intensive firms would tend to fare less well under the BTT. Imagine that firms A and B both have the same before-tax return to capital. Firm A, however, has a larger labor force. Under an income tax, the firms' compensation of their labor forces would not enter the tax base; the firms would tend to pay very similar taxes because of their similar returns to capital. Under the BTT, labor force compensation would enter the firms' tax bases; firm A would thus tend to pay more taxes than firm B. If one associates service industries with high labor inputs, service industries would tend to be more affected by the BTT than by the revenue gainers now in the Administration's package.

The BTT would also have more off an effect on businesses that have relatively large labor inputs because they are inefficient. Under an income tax, a business finds that a bloated payroll boosts its tax-deductible business expenses. Because this reduces the business's taxes, the government, in effect, picks up part of the excessive payroll costs. Under the BTT, payroll costs would not be tax-deductible expenses. Inefficient firms would thus receive no tax break to offset in part their unnecessary payroll costs.

A major group of winners under the BTT would be workers and investors involved in the production of items exempt from the tax at the retain level. Thus, suppliers of food, housing, and medical care would realize an advantage over workers and investors in other fields.

**State And Local Objections**

For state governments and, to a lesser extent, local ones, sales taxes are an important revenue source. If these levels of government were to perceive correctly that the BTT is a type of sales tax, they might complain that it would infringe upon their revenue bases.

people with labor incomes above the wage ceiling. Further, this regressivity has become more significant relative to the overall system in the last 20 years because of the rapid growth of payroll tax rates. Thus one might argue on equity grounds for replacing the payroll tax with a more progressive levy.

As a reason to substitute the BTT for the payroll tax, this equity argument has at least three limitations. First, if progressivity is the objective, it is unclear that the substitution would produce enough of a change to be worth the bother. The BTT is basically a proportional levy. Although it contains some exemptions to move it towards progressivity, their success is more cosmetic than actual. A more basic issue is whether the tax system really requires more progressivity. If it is sufficiently progressive already, the substitution is not needed. In the absence of clear, generally accepted standards of how much progressivity is enough, no firm answer can be forthcoming. A third reservation is that even if the payroll tax can be criticized on equity grounds, public opinion surveys show that people regard it as fairer than the income tax. This suggests that if the government were to replace certain taxes because of their equity problems, the payroll tax would not be at the top of the list.

In terms of efficiency, the BTT may have an advantage over the payroll tax. All taxes tend to reduce people's work efforts because they reduce the reward for work as compared with leisure. The BTT, though, may cause less of a reduction in labor services than the payroll tax. The reason is that whereas the payroll tax places the entire tax load on labor inputs, the BTT distributes the burden across all value-producing inputs. Despite this difference, one might wonder whether the payroll tax, which avoids the income tax's strong anti-saving bias, is a prime candidate for replacement.

An interesting property of the substitution is that it might alter the way in which people perceive the social security system. Because payroll taxes have a superficial (but misleading) resemblance to pension contributions, they help create the false impression that social security's funding is similar to that of a private pension plan in which participants make contributions that are invested and later returned to them with interest. In fact, the social security system is a vast, pay-as-you-go income transfer program in which taxes on current workers fund payments to the system's current beneficiaries.

The substitution of the BTT for the payroll tax would make it more obvious that the social security system functions more like the government's other income maintenance programs than it does like a private insurance program. This understanding should promote a more realistic appraisal of the system's size and structure. Although this is desirable on economic grounds, it

may encounter political opposition from those who would like to retain social security's present resemblance to an insurance system.

**Replacing Some Of The Revenue Gainers Now In The Administration's Tax Plan**

The BTT has several important advantages over the tax hikes proposed in the Administration's package. First, the BTT would not depress saving and investment to the extent that several of the Administration's principal revenue raisers would. This difference arises because the BTT would avoid skewing the relative attractiveness of saving and consumption. In contrast, the Administration's measures would make saving relatively less attractive by increasing its tax load.

Second, in some respects the BTT would be the fairer alternative. It would be a roughly proportional levy on labor and capital income whereas many of the Administration's proposals would further boost the taxation of capital income. Moreover, several of the Administration's ideas, such as "recapturing" some previous depreciation allowances and ending the deductibility of state and local taxes, appear to have been advanced for their revenue yields despite serious equity problems. The BTT would allow such ideas to be scrapped. Working against the BTT, however, is the fact that it would not measure up to some people's notions of vertical equity: it would be a proportional rather than a progressive levy.

Third, the BTT's border adjustments would relieve U.S. producers of some of the tax disadvantages they now face relative to their foreign competition. The Administration's proposals would, if anything, further handicap U.S. producers compared to their foreign rivals by increasing the U.S. tax burden on capital income. Industries such as mining, forestry, and petroleum production are among those that would be hurt most severely by both general and industry-specific revenue gainers in the Administration's package. The benefits of having a more competitive U.S. industrial base argue for replacing some of these items with the BTT.

In some respects, both the BTT and the Administration's revenue-raising proposals have problems. Neither would simplify the tax system. The BTT would saddle taxpayers with additional forms despite being a relatively simple VAT. Although the Administration claims that tax simplification is one of its main goals, many of its proposals are notable for their complexity compared with current law. Both the BTT and the Administration's proposals would also create enormous shifts in tax burdens. While the specific winners and losers would depend upon which alternative was chosen, the shifts would run into the hundreds of billions of dollars over the next few years. Both alternatives would also encounter state and local opposition although the BTT might be seen as slightly less hostile.

The biggest disadvantage of the BTT relative to the Administration's suggestions is the BTT's vast revenue potential. The danger exists that the federal government would eventually use the BTT to expand its tax collections and level of expenditures, in effect converting tax reform into a broad-based revenue increasing effort. This hazard should be discussed at length in any deliberations preceding enactment of the BTT.

To summarize, relying on the BTT in lieu of the revenue-raising provisions in the Administration's plan would be more conducive to capital formation and economic growth. In some respects, the BTT would also be fairer. Additionally, the BTT would allow U.S. producers to compete more vigorously against their foreign rivals. The major shortcoming of the BTT is that it would have a temptingly large revenue-generating ability. Several arguments that could normally be directed against the BTT could also be made against the Administration's proposals: they would complicate the tax code, shift tax burdens, and face state and local opposition. Thus, the BTT would score no worse in these areas of weakness than would its rival.

**Conclusion**

The business transfer tax (BTT) has a number of desirable properties in comparison to the current tax system. A major plus is that it is neutral between saving and consumption. Income taxes, in contrast, have a pervasive anti-saving bias that tends to impair capital formation. Another attractive feature of the BTT is that it is an administratively simple tax. Although its exemptions create some complexity, its use of a single tax rate and its straightforward computation technique, which relies on information already required for computing income taxes, would tend to keep compliance costs low for taxpayers and the government. Another important advantage of the BTT stems from its border tax adjustments. Despite some flaws in their construction, they would tend to relieve some of the tax handicaps that now put U.S. products at a disadvantage in international markets.

In its currently proposed form, most of the BTT's revenues would go towards replacing the employer share of the payroll tax. Perhaps a more compelling use for the BTT would be as a replacement for some of the revenue raisers in the Administration's tax overhaul plan. The Administration's plan contains some extremely desirable features -- most notably, dramatic reductions in corporate and personal marginal rates. The Administration estimates that the marginal rate reductions, the doubling of the personal exemption, and the increase in the zero bracket amount will lose $640 billion from 1986 through 1990. Because the Administration aims for overall revenue neutrality, its tax package requires large revenue gainers to counterbalance these revenue losers. Unfortunately, most of the

revenue gainers proposed by the Administration are unfair, arbitrary, and strongly biased against saving and investment. They are moves away from the goals of tax reform.

If employed as a substitute for some of these proposals, the BTT could collect the needed revenues in a fairer, simpler, and less distortionary manner. It is true that the BTT would produce large shifts in tax burdens if used in this fashion, but the Administration's proposals would also create very large (though different) shifts in tax burdens. A special risk of the BTT, against which precautions should be taken if possible, is the temptation its tax-collecting ability would present to a revenue-hungry government.

Michael A. Schuyler
Economist

**STATEMENT OF R.S. MILLER, JR., EXECUTIVE VICE PRESIDENT OF FINANCE AND ADMINISTRATION, AND DIRECTOR, CHRYSLER CORP., DETROIT, MI**

Mr. MILLER. Yes, Mr. Chairman, thank you. For the record, I am Robert S. Miller, executive vice president for finance and administration of the Chrysler Corp. We operate plants in Missouri and Delaware; and as you mentioned, I am a native of Oregon, so I feel like I am among friends here. I appreciate the opportunity to talk about tax alternatives, and I am also very much aware of the difficulty that you face in coming up with a final tax package. As we see it, Mr. Chairman, our Nation faces four fundamental economic challenges. First, cutting the budget deficit. Second, reducing the trade deficit that is taking millions of American jobs overseas. Third, increasing American industry's ability to compete. And fourth, reforming a patchwork tax system to make it more fair and more efficient. Now, while we believe that any tax reform proposal addressing any one of these issues is worth considering, we think we have here in the business transfer tax a proposal that addresses all four challenges. This is the business transfer tax that was introduced in S. 1102, and we certainly commend Senator Roth for his initiative in bringing this to the forefront.

What makes this particular tax reform most helpful is that an American company could credit its BTT payments against its liability for Social Security payroll taxes. For foreign firms, a companion border tax would be imposed on the fair value of imports, but they would not be able to benefit from the credit. Now, those are the technical details. Basically, the business transfer tax with the FICA credit would have several substantial benefits. First, depending on the rate of the tax, it would generate revenue, anywhere from $20 to $55 billion annually. Second, such a business transfer tax would help make American industry competitive again. If American companies can credit their BTT payments against their liability for Social Security payroll taxes, the BTT should have a minor effect on the prices of American goods in the market. The costs of the tax would be offset by the reduction in FICA taxes. With a FICA credit for the BTT, everyone wins. American producers become more competitive. The U.S. Treasury gains revenues from imports, and consumers benefit from stable prices for American goods. America has two great economic illnesses—the budget deficit and the trade deficit.

The great attraction of the business transfer tax bill, including Social Security credit, is that it links a solution to these great crises. One very important consequence of the BTT is that it would stop encouraging American manufacturers to outsource production to foreign countries and start encouraging overseas manufacturers to produce in the United States. The border tax element of the BTT would bring the American tax system more in line with that of our trading partners. Foreign value added tax systems give foreign producers tremendous incentives to export because taxes on exports are rebated or forgiven. A BTT would leave foreign producers with a choice. They might raise prices to recover the tax, thereby reducing import volumes into the United States, or they could hold their volumes by absorbing the tax and reducing their profits

at home, or they could move their factories into the United States and create jobs. The revenue raised could go to reducing the deficit, to reduce tax rates, or to retain some of the incentives for capital formation that appeal to us in our current tax system.

Mr. Chairman, as we pass the $2 trillion mark on the national debt, your work assumes even greater importance here, and Chrysler is anxious to help and be part of the solution. We are well aware that the proposed 5 percent business transfer tax with FICA credit would increase Chrysler's annual tax bill by about $200 million, substantially all related to Chrysler's imports of Japanese components and vehicles. But we think it is a price worth paying. The business transfer tax is tax reform that would help address the major economic challenges facing our Nation. We hope that, as you consider the BTT and other reform proposals, you will view them in light of what they can do to help cut our trade and budget deficits by helping American business to compete and not simply viewing them as opportunities to raise revenue. Thank you.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Miller follows:]

55-633 0 - 86 - 3

Statement by Robert S. Miller, Jr., Executive Vice President-Finance and Administration, Chrysler Corporation, before the Senate Committee on Finance, Thursday, October 10, 1985

Thank you, and good morning. For the record, I am Robert S. Miller, Executive Vice President of Finance and Administration for the Chrysler Corporation. Mr. Chairman, I appreciate this opportunity to comment on tax alternatives, and I especially appreciate the difficulty of the task ahead of this committee.

As we see it, Mr. Chairman, our nation faces four principle economic challenges.

First, cutting the budget deficit, and its effects on the value of the dollar.

Second, reducing the trade deficit that is shipping millions of American jobs overseas every year.

Third, increasing American industry's ability to compete in the international market.

And fourth, reforming our patchwork tax system to make it more fair and more efficient.

Mr. Chairman, while we believe any tax reform that addresses just one of these issues is worth considering, we also believe this committee and this Congress have an opportunity to make progress on all four of these challenges. One particular proposal I want to discuss today does exactly that. The proposal I'm referring to is the Business Transfer Tax, or BTT, as originally introduced by Senator Roth in S. 1102, also known as "Roth I."

Essentially, the BTT is a tax imposed on the net business receipts of a company at a uniform rate. The tax base would be the total annual revenue of a company, less its payments to other businesses for raw materials, components,

capital equipment and services. Basically, a company's costs for direct labor, interest and tax expense and its profits would be subject to tax. The tax would be imposed annually, and not on a transaction-by-transaction basis.

What makes this particular tax reform work is that an American company would credit its BTT payments against its liability for Social Security payroll taxes. For foreign firms, a companion border tax would be imposed on the fair value of imports, but they would not benefit from the credit.

Those are the technical details. In our opinion, a Business Transfer Tax with a FICA credit would have several substantial benefits.

First, depending on the rate of the tax, it would generate revenue -- anywhere from 20 to 55 billion dollars annually.

Second, such a Business Transfer Tax would help make American industry competitive again.

If American companies can credit their BTT payments against their liability for Social Security payroll taxes, the BTT should have a minor effect on the prices of American products in the market. The costs of the tax would be offset by the reduction in FICA taxes.

With a FICA credit for the BTT, everyone wins. American producers become more competitive. The U.S. Treasury gains revenues from imports. And consumers benefit from stable prices.

But if the BTT payments were made deductible, rather than a credit, the American economy loses out. Consumers would lose because they might have to pay higher prices. American companies would lose because a BTT that is deductible would constitute a new tax. A new tax won't help American business face foreign competition in the domestic market.

Mr. Chairman, America has two great economic illnesses -- the budget deficit and the trade deficit. The great attraction of the first Business Transfer

Tax bill -- a BTT with the Social Security credit -- was that it linked a solution to these two crises.

One very important consequence of the BTT in its original form is that it stop encouraging American manufacturers to outsource production to foreign countries, and start encouraging overseas manufacturers to produce in the U.S.

The border tax element of BTT would bring the American tax system more in line with those of our trading partners. Foreign value-added tax systems give foreign producers tremendous incentives to export, because taxes on exports are rebated or forgiven. For instance, vehicles produced and sold in Japan are subject to a commodity tax in the area of 20 percent. These taxes are rebated on exports. So when a Japanese car lands on the dock in San Francisco, it becomes cheaper, or more profitable, or both compared to its home market.

A BTT would give foreign producers a choice. They could raise prices to recover the tax, and therefore cut imports. They could keep their volumes the same by absorbing the tax and reducing profits. Or they could move their factories to the U.S. The revenue raised could go to reduce the deficit, to reduce tax rates, or to retain some of the incentives for capital formation in our current tax system.

Mr. Chairman, as we pass the two trillion dollar mark on the national debt, your work assumes even greater importance. Chrysler, for one, wants to be part of the solution.

We're well aware that a 5 percent BTT with a FICA credit would increase Chrysler's annual taxes by over $200 million, with all of the taxes coming from our imports. But we believe that is a price worth paying to bring down the value of the dollar so that American business can compete fairly in world markets.

The Business Transfer Tax I've discussed today is a tax reform that would help address the major economic challenges facing our nation. We hope that as you consider the BTT and other reform proposals, you'll view them in light of what they can do to help cut our trade and budget deficits by helping American business to compete, and not just as opportunities to raise revenues.

I will be happy to answer any questions.

The CHAIRMAN. Mr. Meagher.

**STATEMENT OF JOHN K. MEAGHER, VICE PRESIDENT FOR GOVERNMENT RELATIONS, LTV CORP., AND CHAIRMAN, BASIC INDUSTRIES COALITION, INC., WASHINGTON, DC**

Mr. MEAGHER. Thank you, Mr. Chairman. My name is John Meagher. I am the vice president of the LTV Corp. and chairman of a group called the Basic Industries Coalition which is concerned about capital formation issues. I am here to testify both about the existing proposals that are under discussion: The administration's proposal and the staff proposal of the joint committee, as well as Senator Roth's BTT; and an alternative to that, that the Basic Industries Coalition has been working on for some months.

At the outset I would like to say that we think the problem with basic industries is that we arrive at tax reform in an already weakened position, as a result of many things, not the least of which is severe liquidity problems in this economy and the fact that our tax system is basically skewed toward helping imports come into this country, rather than favoring exports or favoring the production of goods and services here in the United States. In this connection, what really happens is that a foreign product is produced overseas; it is not taxed there. It comes to this country; it is not taxed here, and competes with an American product that is taxed here twice, both at the Social Security level and at the income tax level, as well as State and local levels. We have calculated out that the differential of this tax disparity alone amounts to 20 to 40 percent of costs, depending on the country.

This tremendous disadvantage American manufacturers face is at the core of the problem of competitiveness. The results speak for themselves—a $150 billion trade deficit and a huge budget deficit, and the flight of manufacturing firms from the United States—as Steve Miller has just pointed out—to other parts of the world because it is cheaper to do business over there, because the cost of capital is cheaper. So, we, as basic industries, are very interested in the concept that Senator Roth has pioneered. He has, in our judgment, made a major contribution to the whole debate on tax reform by developing the concept that really asks: What are the competitive aspects of our tax system, and how is this tax system, as well as other things, going to impact on the ability of American companies to stay in business? The original bill that Senator Roth introduced, we thought, had considerable merit at the levels it provided.

We are concerned, however, with his latest version, and the reason we are concerned with that, quite frankly, is that many of the companies that are severely import-impacted are at a loss position. And, as we understand the way his proposal would work, that would simply amount to a 7 to 10 percent add-on tax on those companies since they have little or no tax liability in any given year. Such a result is self-defeating. If the proposal is designed to help of trade impacted companies in America, it ought to tax, it seems to us, the companies that are not now paying tax and that are bringing goods into this country more than it taxes similar American

companies. Otherwise, the disparity that I described before and that already exists will simply be exacerbated.

Now, there are large numbers of companies in this country with severe liquidity problems, as I said. They have large net operating loss carryovers. They have unused investment tax credit carryovers. They may be losing money on a current basis, but they are investing money to the extent that they can so they can modernize. And the problem with the latest proposal—although the concept of a BTT we think is a very solid concept and necessary—is that it simply doesn't recognize a very solid American tax principle, which is the ability to pay. In fact, we don't tax people out of business in this country; and I don't think that that was the intent, and I don't think that it is necessary for the BTT proposal to survive and to make a major contribution to the tax reform effort to have this kind of result.

We recommend in its place or as an amendment to it the addition of an ability-to-pay principle, so that it simply doesn't add up to an add-on tax, particularly on people who don't have any ability to pay that tax. If we have to go borrow the money to pay the tax, and that borrowing of the money—if you can get it—puts you out of business, the result is wrong. We don't think that is what you had in mind, and we don't think that that is the result that you wanted to achieve here. We also believe this proposal can be fixed up in a number of ways, but primarily in a way to ensure that it achieves the result we all seek, namely, that it will do something to change the economics of world capacity and that, second, it will ensure that American companies—that it is designed in fact to help and to level the playing field—will have the opportunity to go ahead, proceed with their business, recover, and become active taxpayers. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Mack.

[The prepared written statement of Mr. Meagher follows:]

TESTIMONY

of

JOHN K. MEAGHER

Vice President-Government Relations

The LTV Corporation

Mr. Chairman, my name is John K. Meagher. I am the Vice President of Government Relations for The LTV Corporation and Chairman of the Basic Industries Coalition, Inc. (BIC), an association of over 20 companies and trade associations involved in eight basic American industries. BIC was established in 1983 to provide leadership in developing governmental policy positions to insure the continued health and competitiveness of our basic industries. Since the particular focus of BIC has been to promote capital formation and tax policy alternatives which will provide the basis for long-term economic growth and the ability to compete in the world marketplace, we are greatly concerned about the various tax proposals and welcome the opportunity to discuss our views with this committee.

I am here today to testify about the problems of basic industries in the international marketplace and the extent to which both the Administration's and the Joint Committee staff's proposal impacts on our ability to compete. In so doing, we are here not simply to criticize either proposal nor to participate in any effort to derail or postpone tax reform. Rather, our intention is to suggest alternatives that may assist tax reform to proceed.

Most outside observers believe both proposals will reduce the ability of America's business -- particularly manufacturing -- to compete not only abroad, but here at home as well. We agree with that position. However, it is critical to note that our international competitive position has been declining for some years and many American industries are already in dire straits. The reasons appear to be threefold:

1. "Since 1980", as Edward Jefferson of duPont has pointed out, "the rise in the value of the dollar has put a 50% surcharge on all U. S. goods sold abroad and a 50% subsidy on all imports."
2. Imports have jumped geometrically in virtually every product category as world-wide capacity to produce goods and deliver services has increased.
3. Since 1981, tax changes have significantly increased the cost of capital to American manufacturers vis-a-vis foreign competitors.

As a result, we arrive at this point in an already weakened competitive position. And, I might add, it is not only basic industries which are hurting, it is also high tech, services, and, importantly, agriculture. It is clear that the problems of steel and auto are very much the same as agriculture and semi-conductors. It is world-wide overcapacity and that overcapacity is causing a short-term liquidity problem for much of American business and government and will cause a long-term reduction in our standard of living absent policies to deal with it.

Our concern about the proposals is that they not only ignore the reality of this world-wide situation, but, also, unintentionally exacerbate it. Let me explain.

Under our existing tax law, to use an overworked phrase, the international playing field is uneven. Our present system already encourages imports and discourages exports because it fails to tax imports while taxing domestic manufacturers -- and taxes exports which are taxed again overseas. Also, most exporting countries do not tax exports -- at all -- with the result that goods entering the U. S. enjoy a huge cost advantage over domestically produced goods. We estimate the tax advantage to range between 20% - 40%. This situation, combined with lower wage rates and the high dollar value, simply encourages American businesses to manufacture off-shore and sell their foreign produced goods in the United States. (Exhibit #1 is an article entitled, "New Wave of Off-shore Plants", which appeared in the July, 1985, isssue of Dun's Business Month.)

The results of our existing policy speak for themselves -- a $150 billion trade deficit, a $200 billion budget deficit, declining market shares in most sectors and severe liquidity problems across the economy.

Enter Treasury II and the Staff proposal. Rather than dealing with the fundamental economic problems I've described, they do the opposite. By taking several hundred billion in investment incentives in a five-year period, they will simply increase the cost of capital to manufacturing companies at a time when these firms are already experiencing severe liquidity problems, but must spend to be able to modernize. In addition, they perversely encourage off-shore manufacturing.

A Chrysler, for example, can move a plant to Canada, where it will receive a 7% ITC, two-year expensing of its plant and equipment and sell its product in the U. S. and pay only a 33% maximum corporate rate. In a very real sense, under both proposals, America becomes a tax haven for its own companies. Unfortunately, this means loss of American jobs, earning power and, ultimately, standard of living.

The President and the Staff have proposed and there is strong support for individual rate reductions. They will be meaningless, however, unless America's business base is maintained and expanded. If American's don't have jobs or if their jobs are low-paying service jobs individual tax rates won't matter.

At the outset I stated that we are here not to oppose tax reform, but to assist in its development. In order to do that we believe this committee must act boldly and fairly to deal with the inherent problems of the dollar value, world-wide overcapacity and domestic liquidity -- both private and governmental. A world view of the economic order must be taken, and a policy must be fashioned which reflects the reality of today not the myths of yesterday.

PROPOSAL

Very simply, we recommend extending the fairness doctrine of taxation beyond the shores of America. We think it is not only unfair for certain profitable domestic companies to pay no federal tax but equally unfair for virtually all foreign companies importing goods into the U. S. to also escape taxation. Is it fair, for example, to tax Xerox but not Cannon, to tax Chrysler but not BMW? Hardly.

The fact is that America is the most open market in the world and should remain so if consumers are to have choices, and if we are to have the opportunity to export our goods and services. However, it will not remain open unless something is done about our rising trade deficit and the accompanying fallout from it -- unemployment, liquidity problems, etc.

The alternative to protectionism is a tax policy which will require imports to pay in order to play. Most countries of the industrialized world protect their domestic markets by either major import barriers or taxation. We favor the latter.

In that connection by sponsoring the Business Transfer tax (BTT) Senator Roth is pioneering a major effort toward leveling the international economic arena in which trade is conducted. The BTT is an important concept and deserves serious consideration not just as a revenue source but as a trade tool as well.

Most, but not all members of the Basic Industries Coalition (BIC) support the idea of the BTT. We believe that an alternative revenue source is necessary in order to achieve appropriate tax reform. It is not wise, in our view, to simply raise taxes on business in order to pay for individual tax rate reductions or to simply lower the corporate rate. Such proposals simply make it easier for imports to compete in the American market and place a major barrier in the efforts of domestic manufacturers to modernize and regain competitiveness.

The BTT, in effect, extends the doctrine of tax fairness beyond our shores. It provides the revenues necessary to lower both the fiscal and trade deficits. And, most importantly, it changes the economics of trade on a permanent basis. As a result, it should have a favorable impact on the main cause of our trade deficit -- over supply of world-wide capacity in nearly every product or commodity.

I would be remiss, however, if I didn't cite very real and serious problems with the latest BTT proposal of Senator Roth.

In concept, the BTT is designed as a border tax adjustment mechanism which can equalize the tax burdens between foreign and domestic producers. While it has positive revenue effects, which should be favored, the primary policy reason for its adoption should be trade-related.

S.1102 embodied that notion and really amounted to a border tax adjustment mechanism. It recognized that social insurance costs are born exclusively by American corporations and provided an offset against FICA taxes for the BTT.

The latest BTT proposal eliminates the FICA offset and simply allows a deduction of the BTT against income tax liability. Unfortunately, for companies with little or no income tax liability, the new BTT amounts to a 7% to 10% add on tax. For loss companies, like many in BIC, this tax could force us out of business.

It is ironic that most of the companies in this category are or have been the victims of severe import pressure -- exactly the problem the BTT conceptually should be addressing. In fact, the opposite would occur. Foreign competitors would gain a major advantage over domestic companies having import and financial difficulties. Also, as the revenue projections indicate, most of the new revenue would come not from foreign firms but from American firms. The opposite should occur.

We urge that this proposal be modified to insure the result we all seek.

Specifically, we recommend the enactment of the Business Alternative Transfer Tax (BATT) which would more nearly harmonize our system with those of our principal trading partners. The BATT would impose a 15% to 20% tax on the net amount of goods and services transferred by a business during the year. This would apply to goods from whatever source, obviously to include imports. It would contain an ability to pay principle similar to that in the existing federal income tax system and would be set up as an alternative tax meaning that businesses would be allowed to credit domestic FICA and income taxes against it as well as allow the use of ITC and NOL carryovers. In this respect, it adopts the principle contained in and could have similar results to the alternative minimum tax proposals sponsored by members of this committee. Unlike the BTT proposal of Senator Roth, it would not tax loss companies out of business.

The BATT makes sense to us for a number of reasons:

1. It will raise revenue needed to allow tax reform to proceed consistent with the President's proposal and those which have been expressed by the Chairman and other members.
2. It will help alleviate our trade deficit problems and should serve as a meaningful alternative to protectionist actions.
3. It will be a positive step toward forcing the rationalization of world-wide capacity.

This latter feature is essential if there is to be stabilization of supply and price. Since this process will be a long one, it is critical that this change in tax policy be permanent. Ultimately, we must deal with the economics of capacity if we are to survive as a major industrial power. Our existing tax system and the President's proposal simply encourages increases in capacity overseas and decline in capacity here at home. Is this fair? We think not.

The net affect of this proposal will be to reduce the value of the dollar in the short term and force world-wide capacity rationalization in the long term.

In the absence of policies to deal with both, our commerical future is at stake and our way of life threatened.

EXHIBIT #1

# New Wave of Offshore Plants

*For the first time, companies are expanding factories overseas to make products for the U.S. market.*

*by Lynn Adkins*

If you can't beat 'em, join 'em," has become the battle cry of American companies as they rush abroad to manufacture products that formerly were "Made In America." Foreign affiliates of U.S. companies plan a 22% hike in manufacturing investment this year, compared with only a 4% increase in 1984, according to a Commerce Department survey. "At this very moment," reports Bernard O'Keefe founder of EG&G, Inc., "a half-dozen division managers are looking at Ireland, Puerto Rico, India, Thailand, Malaysia and other nations to determine whether we can source components there or even set up our own plants to make products for sale there and in the U.S."

Behind the move is the unflagging strength of the dollar. Even though companies have been doing everything possible to become more competitive, including slashing labor and management ranks, closing outmoded plants and modernizing others and improving product quality and service, they have not been able to close the cost gap. "Our members tell us they have taken 25%-to-30%, and as much as 35%, out of the cost out of their product," says National Association of Manufacturers' President Alexander Trowbridge. "But this is still not enough." The dollar's drag has been too much to overcome. "The year 1984 was a watershed," says NAM Vice President Lawrence Fox. "Corporate America kept waiting for the dollar to weaken. It hasn't, and now they feel the only way to compete is to go abroad."

To be sure, manufacturing products overseas and using foreign suppliers is not a new phenomenon. America's corporate giants went overseas in droves a generation ago and only curtailed this investment in the late 1970s when investment costs grew prohibi-

tive as the dollar sagged and labor market conditions became onerous. That expansion, however, was designed to serve growing overseas markets, and, at that time, 25% of U.S. exports stemmed from the shipments of U.S. companies to their overseas affiliates. Today, in sharp contrast, the dollar is super-strong, foreign sales are weak and plants overseas are not being supplied with components from their U.S. parents. Moreover, foreign suppliers are not being used *in addition to* U.S. suppliers, but in place of them, says the NAM's Fox.

In this new wave of investment, those companies with offshore facilities in place have begun to manufacture more product overseas. For example, Caterpillar Tractor Co. announced last January that production of its new D6 tractor would be done entirely at its Glasgow, Scotland, plant and that all manufacture of its track-type loader (a piece of equipment that looks like a bulldozer with a scoop) would take place at its facility in Grenoble, France. The reason: it is substantially cheaper to build these products abroad and ship them back to the U.S. market for sale, according to Caterpillar. Originally, some of the D6 production was slated for the company's Davenport, Iowa, facility, which had also been producing the loaders.

Lower costs abroad also has forced machine-tool builder Brown & Sharpe Manufacturing Co. to cut production at its Kingston, Rhode Island, plant and boost production in its facility in Switzerland, according to an executive of the National Association of Machine Tool Builders. Some of that product will be shipped back to the U.S.

E.I. du Pont de Nemours & Co., which over the past decade has allocated between 16% and 17% of its annual capital spending for overseas projects, is increasing its foreign commitment to 26% this year. "You get more bang for your bucks building overseas than in the U.S.," says Vice Chairman Richard E. Heckert. Most of the products from this new capacity will be marketed abroad, but, he says, "some of it will come back to the U.S." Moreover, he contends, "if a company has a choice of building a plant in New Jersey and building a plant in Asia, there isn't much of a choice. The plant will be built in Asia because the cost of capital is cheaper and so are materials."

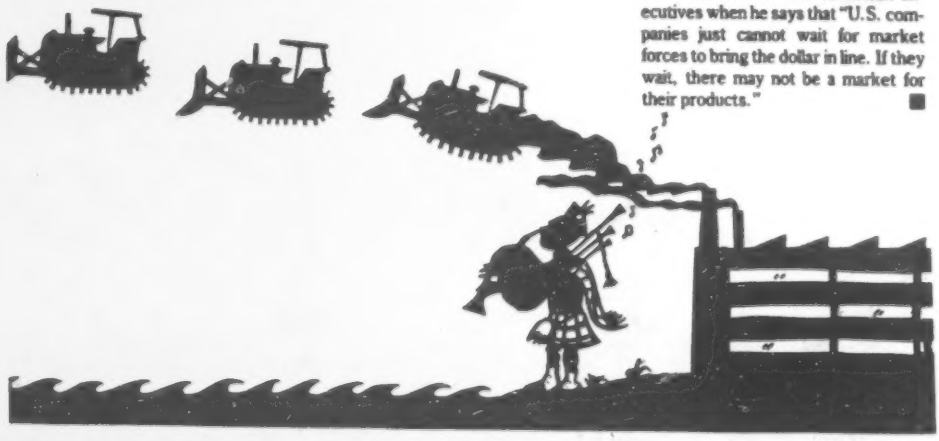
Eastman Kodak Co. is moving in the same direction. The company has consolidated some of its domestic production facilities in favor of locating "a modest amount of assembly and subassembly work at our locations outside the U.S.," Chairman Colby H. Chandler told the Senate Finance Committee in April. "These efforts are all new to us," he added.

Also on the upswing are joint ventures with foreign partners to produce goods for the U.S. market. In April, Chrysler Corp. announced it will build automotive components in South Korea with the Samsung Group for shipment back to the U.S. for assembly.

And Ohio's Minster Machine Co. formed a joint venture with a Taiwanese firm to produce high-speed metal forming equipment for sale in Asia. The venture has been so successful that Minster is now selling the equipment in the U.S. as well.

These moves obviously will have enormous repercussions on U.S. employment, but many industry leaders argue that the long-term consequences are even more serious. They believe that even if the dollar does come down appreciably, the likelihood is that the American companies that have set up overseas sources in one form or another will continue those operations and relationships. "Once such actions have been taken, companies have made a two-to-ten year commitment," contends the NAM's Trowbridge. "Those decisions are not changed quickly."

Still, Trowbridge is surely echoing the sentiments of most American executives when he says that "U.S. companies just cannot wait for market forces to bring the dollar in line. If they wait, there may not be a market for their products." ■



**STATEMENT OF JAMES H. MACK, PUBLIC AFFAIRS DIRECTOR, NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION, WASHINGTON, DC**

Mr. MACK. Good morning, Mr. Chairman. I am Jim Mack. I am public affairs director of the National Machine Tool Builders' Association. We appreciate the invitation to discuss the concept of business transfer tax in the context of basic tax reform. NMTBA has long maintained that fundamental changes in tax policy must not be considered without an assessment of the impact of those changes on our international competitiveness. In our view, the administration's and, more recently, the Ways and Means Committee staff's apparent failure to accurately evaluate this impact constitutes the major failing of their respective tax reform proposals. The administration and the Ways and Means Committee find themselves in a predictable dilemma. Their steadfast adherence to a specific individual rate target and to revenue neutrality, coupled with their refusal to consider alternative funding mechanims, has inevitably resulted in the repeal or depletion of important investment incentives.

Mr. Chairman, that is not tax reform. It is a sure-fire formula for higher trade deficits, lower industrial capacity, and more underemployment. The BTT, on the other hand, by providing a border neutral revenue source with which to pay for the retention of crucial capital cost recovery provisions as well as significant rate reductions will lead, in our view, to greater capital investment, to greater productivity, and to greater international competitiveness. That is real tax reform, and we are pleased to endorse the BTT concept. We note that Senator Roth's revised BTT proposal no longer provides for the credit of BTT revenues against a firm's liability for FICA, but instead allows the BTT to fully be deductible against corporate income tax liability. Perhaps the committee should consider the feasibility of adopting an approach which retains aspects of both proposals by permitting a taxpayer to first offset his FICA liability via the credit and then apply the remaining BTT revenues to reduce his income tax liability. Or, alternatively, a taxpayer could be provided with an option to offset the BTT against either or both his FICA and income tax liabilities. In this way, employers could reduce their labor costs and still make appropriate adjustments in their taxable income. Under the revised BTT proposal, it is not clear what treatment is to be accorded those taxpayers who, as a result of negative profit margins, incur no income tax liability in a given year.

We believe that consideration should be given to the adoption of a carry-forward or carry back provision regarding the BTT liability. A provision should also be made to offset a company's BTT liability against any minimum tax that you might decide to adopt. And finally, consideration should be given to permitting a company to use its BTT of tax liability to absorb unused investment tax credits. We believe that because BTT is, in effect, an excise tax on business and not a consumption tax in the purest sense, it is appropriate that its revenues be applied to offset other business liabilities, such as those imposed by the proposed elimination of accelerated depreciation schedules and the investment tax credit. We are

therefore gratified that Senator Roth's proposed expensing cost recovery system is predicated on a recognition that in order for U.S. businesses to remain competitive, the Tax Code should not return to the pre-1981 anticapital bias. We believe that ECRS could spur an enormously productive capital investment cycle, thus providing the foundation for improved U.S. competitiveness. However, because the ECRS relies on asset classifications established by CCRS, we do want to point out that we believe machine tools have been improperly classified under the CCRS system; and we refer the committee to our recent testimony on that point.

We understand that Senator Roth's proposal contemplates some leftover revenues from the BTT, and we suggest in our testimony a number of options that the committee may wish to consider in this regard, including permanent retention of a lower ITC or a gradual phaseout, elimination of recapture, phasein of complete expensing, perhaps expensing at a higher rate. Finally, we urge the committee not to adopt measures such as the House Ways and Means Committee corporate minimum tax, which under the guise of cosmetic fairness effectively aviscerate the investment incentives that the BTT was intended to preserve. Thank you, and we will be glad to respond to your questions.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Mack follows:]

STATEMENT BY
JAMES H. MACK
REPRESENTING THE
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 10, 1985

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I. INTRODUCTION

Good morning, my name is James H. Mack. I am Public Affairs Director for the National Machine Tool Builders' Association (NMTBA), a trade association representing companies which account for more than 85 percent of machine tool production in the United States.

NMTBA appreciates the invitation to discuss the concept of a Business Transfer Tax (BTT) in the context of basic tax reform. We understand that Senator Roth's plan for basic reform is still in draft form. Before proceeding with our specific comments concerning the proposal, we would like to direct the Committee's attention to testimony delivered last week by NMTBA Chairman James L. Koontz, who appeared before the Committee to address the President's tax "reform" plan.[1] That statement documents, in some detail, the current state of the domestic machine tool industry. Let me summarize by noting that, while there have been some positive signs, most machine tool builders continue to experience severe financial strain due to the modest recovery in shipments. Substantial import penetration -- measured by value, machine tool imports presently

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[1] See, generally, Congress, U.S. Senate, Committee on Finance, Statement by James L. Koontz, President and C.E.O., Kingsbury Machine Tool Corp (representing NMTBA), October 2, 1985 (99th Cong., 1st Sess.).

account for more than 40 percent of domestic consumption -- also clouds prospects for further recovery. And, as we told the Committee last week, the elimination of crucial investment incentives provided by ACRS and the ITC will have a devastating impact on capital spending -- both by the industry's customer base and by the industry itself. The result will be a less competitive manufacturing base for America.

## II. THE CONCEPT OF A BUSINESS TRANSFER TAX

NMTBA has long maintained that fundamental changes in tax policy must not be considered without an assessment of the impact of such changes on the international competitiveness of U.S. businesses. This is especially true in light of America's unprecedented trade deficit and the fact that this country is facing a crisis with regard to its international competitive standing. In our view, the Administration's -- and, more recently, the Ways and Means Committee staff's -- apparent failure to accurately evaluate this impact constitutes the major failing of their respective tax "reform" proposals. The Ways and Means staff approach further exacerbates the problem by wiping out the minimal investment incentives which remain by including them as "tax preferences" in the new corporate minimum tax and then locking capital intensive industries of all sizes into a permanent minimum tax position.

It is generally recognized that our tax code favors consumption while discouraging savings and investment. Many of the so-called tax preferences now included in the code have, to varying degrees, the effect of mitigating the code's bias against savings

and investment. It is these very investment and savings incentives which are eliminated by the Administration and the Ways and Means Committee staff, in order to achieve individual and corporate rate reductions.

The Administration and the Ways and Means Committee find themselves in a predictable dilemma. Their steadfast adherence to a specific individual rate target and to revenue neutrality, coupled with their refusal to consider alternative funding mechanisms, has inevitably resulted in the likely generation of low economic growth. Mr. Chairman, that's not tax reform. It's a sure fire formula for higher trade deficits, lower industrial capacity, and more under-employment.

The BTT, on the other hand, by providing a border-neutral revenue source with which to "pay for" the retention of crucial capital cost recovery provisions as well as significant rate reductions, will lead to greater capital investment, greater productivity and greater international competitiveness. That is <u>real</u> tax reform and we are pleased to endorse the BTT concept. We commend Senator Roth and his staff for recognizing that an environment conducive to long-term economic growth is essential to America's continued competitiveness -- both at home and abroad.

## III. FICA OFFSET VS. INCOME TAX LIABILITY OFFSET

We note that Senator Roth's revised BTT proposal no longer provides for the credit of BTT revenues against a firm's liability for the employer portion of Social Security payroll taxes (FICA), but instead allows the BTT to be fully deductible against corporate

income tax liability. We understand that several concerns led to this shift -- a major one being that a BTT imposed at an increased rate of 7 to 10 percent would more than offset a firm's FICA liability and thus, result in the imposition of a new business tax.

Perhaps the Committee should consider the feasibility of adopting an approach which retains aspects of both proposals by permitting a taxpayer to offset his FICA liability via a credit, while applying the remaining BTT revenues as a deduction against income tax liability. Alternatively, a taxpayer could be provided with an option to offset the BTT against either or both his FICA and income tax liabilities. In this way, employers could reduce labor costs and still make appropriate adjustments in their taxable income.

Under the revised BTT proposal it is not clear what treatment is to be accorded those taxpayers who, as a result of negative profit margins, incur no income tax liability in a given year. Consideration should be given to the adoption of a carryforward/carryback provision regarding the BTT deduction. Provision also should be made to offset a company's BTT liability against any minimum tax the Committee should decide to adopt. Finally, consideration should be given to permitting a company to use its BTT liability to absorb unused investment tax credits.

## IV. CAPITAL COST RECOVERY

NMTBA believes that because the BTT is, in effect, an excise tax on business and not a consumption tax in the purest sense, it is appropriate that its revenues be applied to offset other business liabilities -- such as those imposed by the proposed

elimination of accelerated depreciation schedules and the ITC. We are, therefore, gratified that Senator Roth's proposed Expensing Cost Recovery System (ECRS) is predicated on a recognition that in order for U.S. businesses to remain competitive, the tax code should not return to the pre-1981 anti-capital bias embodied by the ADR system.

NMTBA applauds the ECRS as a vast improvement over the Administration's CCRS and, particularly, the Ways and Means Committee staff option. ECRS, unlike those two proposals, retains an essential feature of any truly effective depreciation scheme -- the ability of equipment purchasers to recoup their investments in a timely manner in order that they may reinvest in modern productive assets. We believe that the ECRS could spur an enormously productive capital investment cycle, thus providing the foundation for improved U.S. competitiveness.

However, because the ECRS relies on asset classifications established by CCRS, we want to point out that machine tools are improperly classified. The overwhelming majority of today's most productive machine tools are computer controlled. Consequently, the design, manufacture and application of both individual machines and systems are closely intertwined to the state-of-the-art of the computer control itself. That is why machine tools properly belong in the depreciation class which includes computers and other equipment typically subject to sweeping technological change.

We refer the Committee to our recent testimony which includes a detailed examination of appropriate machine tool

depreciation classification.[2] We urge you to bear in mind that access to the very latest technology is a competitive necessity for the U.S. machine tool industry and its customers. A depreciation schedule which amortizes machine tools over too lengthy a time period will not provide the cash flow necessary to replace technologically obsolete equipment in a timely fashion.

Finally, we note that Senator Roth's proposal contemplates some "left over" revenues following introduction of the BTT. We suggest the following as options which the Committee may wish to consider in this regard: the permanent retention of a lower ITC or, alternatively, a gradual ITC phase-out; elimination of the Administration's recapture proposal; a phase-in of complete expensing or, alternatively, expensing at a rate in excess of 50 percent as called for by the ECRS. Each of these proposals would provide further shoring up of capital cost recovery.

## V. CONCLUSION

NMTBA is encouraged by Senator Roth's proposal -- drafted as it was with an eye towards the realities of competition in today's global market, it represents a significant step forward in the tax reform debate. However, we urge the Committee not to adopt measures such as the House Ways and Means Committee's corporate minimum tax which, under the guise of cosmetic "fairness", effectively eviscerate the investment incentives the BTT is intended to preserve.

Thank you. I would be happy to respond to your questions.

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[2] See, Statement of James L. Koontz, supra, at pp. 6-8.

The CHAIRMAN. Mr. Mack, I do have several questions, which the other witnesses may want to address themselves to as well. Would you target the revenues generated by the BTT, whether we use it to offset FICA or other taxes or as a deduction against income taxes, or simply use those revenues to reduce the deficit.

Mr. MACK. We would be opposed to that.

The CHAIRMAN. Oh, I understand that you would be opposed to that, but I am curious about your statement that you regard the BTT as an excise rather than a consumption tax. Give me your definition first of a consumption tax, before I go on.

Mr. MACK. As I said, it is not a consumption tax in the purest sense. In the case of a VAT, through an invoice and credit method, you are passing and crediting it along the stream of commerce. The BTT is paid by the business, and the business could either absorb it or pass it along as it chooses.

The CHAIRMAN. But isn't this true of all taxes?

Mr. MACK. In the purest sense, one could say that corporations are, in a sense, a tax collector for the Government. Sure.

The CHAIRMAN. In that case, they are all consumption taxes. The excise tax is a consumption tax, business transfer, value added—they are all consumption taxes.

Mr. MACK. In that sense, yes. But, as I said, in the purest sense it is a tax on business as opposed to a pure tax on consumption. But I see where you are coming from.

The CHAIRMAN. Interestingly, most economists—in fact, most people—call excise taxes consumption taxes, whether it is the telephone excise tax or the windfall profits tax, which is not a profit tax but an excise tax. And you are calling the business transfer tax an excise tax, but you are not calling it a consumption tax, which I am intrigued with.

Mr. MACK. As I said, in the purest sense I think that is true, but I see where you are coming from. One could go either way.

The CHAIRMAN. I take it that you would be happy with the business transfer tax so long as it is applied against some tax that the business owes, whether it is FICA or unemployment or workers' compensation, or something that the business owes; but you would be opposed to it if it were strictly a deduction against income tax?

Mr. MACK. No; I think that Mr. Meagher and Mr. Miller have raised some problems, and that is that FICA is a tax that every business pays. Not every business is in a position to pay an income tax. Our industry has been in a loss position since 1982. We would love to pay income taxes. Many of our members aren't paying them these days. I guess the concern that I would have is that, if a company has no income tax liability and if you don't provide some other mechanism for them to offset the BTT liability, whether it is through FICA or through carryforwards or carrybacks, I think you do create some distortions that Mr. Meagher outlined.

The CHAIRMAN. Mr. Miller, if the BTT is not used as an offset against FICA or some similar tax, you are opposed to it?

Mr. MILLER. We would be prepared to consider it. I think the important feature that we found in S. 1102 has to do with the FICA offset; and I am not too sure about the semantics of consumption tax and excise tax, but what I think is important is that in S. 1102, where there was the FICA offset, there would be minimal or no

impact on the price of goods that are made in America. And I think, therefore, for the broad range of goods that at least some market shares produce in America, the consumer would not see any raising of his prices. It would be the foreign producer competing in America who would now have a tax bill that he would have to eat because, presumably, he would have to maintain his price level to be competitive with the domestics. And that is where I think that we can stay away from the rhetoric of what is a consumption tax. If the tax as constructed does not cause a price increase for American produced goods, the consumer should win. As to where the money goes, that is the job of your committee. We are suggesting that, as you tinker with the Tax Code, please try and do something that helps us with our trade deficit.

The CHAIRMAN. Mr. Meagher.

Mr. MEAGHER. I would answer your question "yes," if it was posed like that, and I think the group would. I have told Senator Roth that privately. I think that we ought to look at this as a new kind of a tax system that is being created. I don't think it needs to fall under the rhetoric or the precedence of old tax systems. The fact that there is the use of a FICA offset or a deductibility principle or whatever is simply a convenient way of dealing with. We look upon this basically as a new kind of tax system that is primarily—in our view should be primarily—a trade tool; that it is something to level the international playing field so that American companies can compete fairly. We don't look at it primarily as a revenue measure. This isn't an excise tax. We think it has the features of a consumption tax, which it clearly does; but in effect what Senator Roth is attempting to do is to create a new kind of tax system that will deal with very specific problems that have been occasioned by what is happening in policies overseas as well as here and the world marketplace.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. Let me start out by saying that, to me, the basic motivation of tax reform has to be to develop long-term tax policies that will enable this country to compete in world markets and to meet the challenge of the technological revolution that we are going through. And if we fail to face that challenge, then I think we are on a decline. I think that this tax proposal does meet that challenge.

Let me start out by saying that, whether it is Roth I or Roth II or Roth III, we are still in the process of trying to develop the kind of approach that will meet that goal; and I recognize that there are certain problems with respect to our basic industries. You are absolutely correct. We are not trying to penalize them because I happen to be a strong believer that the United States as a shield for the free world has to have a strong, vital, basic industry. So, we are looking at the problem. There are advantages and disadvantages offsetting against FICA. It helps some, but then there are others that it doesn't. Some it may be some kind of combination. We have to keep in mind, of course, that we have to have revenue because I think the President has rightfully said it has got to be revenue neutral.

The one thing I want to urge upon you, and I appreciate the comments that were made today, that in order to introduce this kind of

new approach, it has also got to be sellable to the individual. Politically, there are a lot of people who think this is a very risky kind of business, but that is the reason it is so important that we do something about the middle class. I think we can make some changes if we demonstrate to the individuals—the working people—that they are going to benefit. Of course, that is the reason we are proposing, as Rudy said earlier, to continue this reduction in marginal rates, so that we have their political support in making this kind of very significant change.

Now, let me go back. The administration has said its approach wants to be revenue neutral, and they have made some changes in the House; but it seems to me, instead of being revenue neutral, they are negatively impacting on capital recovery, the very kind of—in other words, we are undoing in the administration and what the House Ways and Means Committee has proposed, what we were trying to accomplish in 1981, to enable American business to be competitive. And that is one reason American business is not supporting these changes. Would you agree with that?

Mr. MEAGHER. Absolutely. I think that what we have done since 1981 in numerous ways is take several steps backward. Many experts say that the value of the dollar is the real reason for our trade deficit. It probably, as Mr. Jefferson at Du Pont has said, is only 50 percent of the problem; but the rest of the problem is certainly, as far as businesses' ability to compete, is of long standing; and it goes to the questions of what kind of tax system do we have vis-a-vis, the kinds of tax systems in other countries. And so, we need to deal with the fundamental question that you raised: How does a combination of these systems impact on the ability of American corporations to compete? And that is the question that you have been so vigorously working on with your proposal.

Senator ROTH. My time is almost at an end on this round, but we are greatly concerned about the trade imbalance. And it seems to me that this approach is a major answer to that problem, in contrast to, say, a straight out-and-out surtax which, No. 1, is probably invalid under GATT and, No. 2, raises a number of questions. But I would like to have a quick answer to this: Do you see the BTT as being a significant factor in helping in the trade picture?

Mr. Mack, do you want to start?

Mr. MACK. Yes, we do. Again, provided you use the revenues that the BTT generates to either offset other business tax liabilities to keep businesses competitive or, in a negative sense, I guess, not doing some of the horrible things that are done to capital formation and capital cost recovery by the other proposals that are before you.

Senator ROTH. We propose to use a significant amount of the revenue for that purpose.

Mr. MACK. Yes, you have.

Senator ROTH. Mr. Miller.

Mr. MILLER. S. 1102, which included the FICA offset, is definitely going to help our trade posture. It also creates the revenue opportunity to also restore some of the incentives for capital formation. But with or without that feature, S. 1102 by itself, the FICA offset feature definitely helps trade.

Senator ROTH. Mr. Schuyler.

Mr. SCHUYLER. My feeling is that, with the border tax adjustments, both the original and the revised version of the BTT would greatly help American industry because it would put us on a more even tax footing with our foreign competitors.

Senator ROTH. Thank you. Yes?

Mr. MEAGHER. I would just like to add one other thing, Senator. I think there are two reasons why it helps in trade. One is the immediate problem that it obviously brings in revenue and deals with the trade deficit; but the other, and I think far more fundamental and important, is that it ultimately deals with the question of overcapacity in the world. And the real reason that we are having trade problems is the fact that we have vast overcapacity in almost every industry, including agriculture. There is simply too much supply and not enough demand for the goods and services. So, since America is the largest market, or the second largest market at least, we are being flooded with imports. And what the permanent change of the type that you are suggesting does, in our view, is to change the decisionmaking of the foreign manufacturer, as well as the American manufacturer, to really have to make a decision as to whether or not he or she wishes to put in that additional plant or equipment. Ultimately, we have to deal with that rationalization of capacity worldwide, or we are not going to solve this trade problem, short of protectionist kinds of measures.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. If we are to have any form of value added tax or BTT, why should it be a 5-percent rate or 7-percent rate? What are the comparable rates for value-added taxes in the rest of the world? Do you know?

Mr. SCHUYLER. I would say in Europe they are generally in the range of 10 to 20 percent, 20 percent or so being on the high side, found in a country like France. Some goods classified as luxuries, such as jewelry, automobiles, cameras, are at higher rates in some countries.

Senator DANFORTH. It would seem to me that a good case could be made if we are going to go for it, let's go for it, rather than just put a toe in. I have resisted signing up for value-added tax or variations upon the value added tax proposals for a number of reasons. For one, I have assumed that they are inflationary—instantly inflationary. I have assumed that they are regressive. I have assumed that they are money-making machines as far as Government is concerned. And if we ever want to get a grip on Government spending, we don't want to have anything resembling a value added tax. And then I have assumed in this administration that they are a lost cause. [Laughter.]

On the other hand, I think you are absolutely correct of the trade consequences. We talk about all the problems we have in international trade. Clearly, one of them is the fact that the tax systems around the world differ, and that our tax system is much less sensitive to the needs of business to deal on an international market than are the tax systems of our trade competitors. I won't ask you to get to the lost cause concern. Maybe we can, for a change, convince the administration of something. On the problems of the inflationary aspect, the regressive concerns, the regressive tax system, and that once you start it, it is a money-making ma-

chine that won't quit; Government will get bigger and bigger and bigger—how do you deal with those concerns?

Mr. MILLER. If I might jump in here first, I am disturbed that the genius of Senator Roth's business transfer tax proposal in S. 1102 is getting branded with some of the problems that might more generally apply to value added taxes. The original construction called for the FICA offset. This means that, for American produced goods, in the end there will be very little cost impact. This bill was constructed to reduce the impact on those who provide American jobs; and, therefore, our costs in producing American goods is not going up. Therefore, our price is not going to go up. Therefore, it should be noninflationary as to American goods production; and therefore, it also is not regressive. In fact, by creating jobs, you could say in the overall sense it is just the reverse. It is helping those people we are trying to help, and it is also—pardon me?

Senator DANFORTH. Helping labor intensiveness?

Mr. MILLER. Yes, it does. And then, finally, because it is creating some revenue, you can then go after the tax rates on the poor as an offset, for example, in order to eliminate whatever residual regressivity you may find. As to the money-making machine, we have only one example in the United States that is roughly comparable; and that is the Michigan single business tax. That was implemented in 1976 as a 2.35-percent rate. Michigan went through hell in 1980 and 1981. The State was bailed out by some Japanese banks in the end because it got so bad. They went after personal income tax rates, but they never touched the single business tax rate, which was the same kind of money-making machine that you see in this. So, that is going to be up to you, not me, to decide in the future; but in the one example we have in the United States, the rate has been left intact at the original rate of 9 years ago.

Senator DANFORTH. Does anyone else want to comment?

Mr. SCHUYLER. Yes, let me jump in at this point, if I may. In response to the question of whether the tax would be inflationary, I would say the real question is whether, if producers attempted to pass on the tax, consumers would be willing to increase their money spending sufficiently to accommodate the higher prices. I would argue that, unless the Federal Reserve engineered an accompanying expansion of the money supply, the tax would not alter the total amount of money consumers were willing to spend. It would not be possible, therefore, for producers to pass on the tax. To talk specifically about a revenue neutral suggestion such as the BTT, a point made by another witness is extremely relevant; namely, producers' costs would not be rising. So, there would not be added cost pressures on producers as a result of the BTT. One tax would be going up; another would be coming down. I do not see this as being inflationary. If the tax is not inflationary, it will be passed back to the workers and capital owners involved in the production process. As a result, it will be a roughly proportional tax on people's incomes. It is not a progressive tax; it is proportional; and it is certainly not regressive. Just from the point of covering all bases, I would note that in both the original and revised versions of the Roth bill, there are several exemptions for what you might call necessities—housing, food, medical care—that, even if the tax were to be passed forward, which I don't think it would be,

would serve to soften the sharpest edges. As to the tax being a money machine, I, personally, have that fear with any new major tax initiative. I would say I am less concerned about it in this case because of the sensitivities that Senator Roth has shown to that danger and the attempts he has made to try to bring it out into the open. I would also add that, if one looks at the European experience, one finds that after value-added taxes were in place and had been raised a little bit, they then became a fairly stable component of the overall tax mix. There was no tendency for them to keep ratcheting upward relative to other taxes.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman, and thank you, gentlemen, for being here this morning and for your statements. Do I understand you all correctly to say that you would favor this tax, whether or not there is a tax reform package?

Mr. MEAGHER. I certainly would.

Mr. SCHUYLER. Yes, sir.

Senator SYMMS. Mr. Miller.

Mr. MILLER. Yes.

Senator SYMMS. Mr. Mack.

Mr. MACK. Let me turn it around, Senator. I think if you are going to consider tax reform, this needs to be an element in it. If you are going to really reform taxes, it seems to me that you have got to look at the whole gamut of options. One of the problems that both the administration and the Ways and Means Committee have is that, by refusing to lay on the table this kind of proposal, the inevitable results that you are going to end up reducing all kinds of investment incentives in an effort to achieve the rate reduction you want and revenue neutrality.

Senator SYMMS. Let me ask you another question here. In this morning's Wall Street Journal, there is a very interesting article by Paul Craig Roberts and Gary Robbins, and the headline says: "Tax Reform Aims at the Very Industries up for Protection." And they start out in the first paragraph and say: "Washington is practicing a new form of economics that has replaced both the demand and supply side economics. It is called blind-side." [Laughter.]

"Policymakers in both the administration and the Congress have failed to make the obvious connection between taxation and international competitiveness." And then he goes on to say that the Rostenkowski bill has developed a tax plan that by their calculations would raise the cost of capital by 14 percent. They go on and say that agriculture, for example, which is in line for a budget-busting multimillion-dollar bailout would find its cost of capital raised by 22 percent, textiles and shoes, which are in the forefront of protectionist legislation, would find they are further undermined by competitive costs 14 percent, higher cost of capital. Do you think this would lower the cost of capital or what would it do?

Mr. MEAGHER. I don't think it lowers the cost of capital. What it tries to do is to raise the cost of capital or equalize the cost of capital.

Senator SYMMS. No, that isn't my question. I am saying that Dr. Roberts is saying that, at the current——

Mr. MEAGHER. Oh, absolutely.

Senator SYMMS. You are saying that the BTT would have no impact or what impact?

Mr. MEAGHER. I think that the BTT would have the effect potentially of lowering the cost of capital in this country because the extent to which it lowers the budget deficit and deals with the trade deficit, then theoretically at least people believe that interest rates will come down and therefore the cost of capital will come down. But I agree 100 percent with that Paul Craig Roberts, and I think that the reason that I would favor this, and that most of the people in my coalition—not all of them do, but most of them favor—is because it is an alternative to protectionism. It deals with the fundamental economics of trade, and it forces people to make economic choices about their capacity and their willingness to expand or contract. So, I think that a proposal of this type is vital as a trade measure primarily. It has positive revenue aspects that can be used to deal with other issues. However, it is time that the country recognize the connection between tax and trade and the tremendous disparity that exists, because of the failure of our tax systems, vis-a-vis the rest of the world, to be relevant to today's world market.

Mr. MILLER. Senator Symms, let me tell you what this means for Chrysler. The Treasury II bill, the loss of the investment incentives, combined with the lowering of corporate tax rates in general, leaves us in a position of about a wash. What we would lose in the capital incentives, we would gain in the lower overall tax rate. That is a wash; but what that would induce us to do is to go look at other countries that offer the incentives; and we may well end up over time investing overseas where there are the capital incentives, selling the goods here and recording our profits in a country with a low tax rate. So, while it is neutral to us, the over-time impact will be to drive the investment overseas. The BTT, on the other hand, with the FICA offset, is what brings capital back here.

Senator SYMMS. You are saying that Treasury II's proposal would encourage you to go offshore?

Mr. MILLER. Yes, sir.

Senator SYMMS. Thank you, Mr. Chairman. Thank you all very much for excellent statements.

The CHAIRMAN. Senator Long.

Senator LONG. I am concerned about the big disadvantages which I think are disastrous disadvantages that American business suffers today when you try to produce here compared to producing overseas. We have an advantage in that we have more research and more knowledge to work with; but we are discovering that, even though we achieve at an enormous cost—and I am for that—that it is so easy for anybody just to go take that information overseas and then use that overseas with the advantage of cheap labor, a more favorable tax system, the dollar differential; and we are just not competitive against that, in most cases, if you add all that up. And it is devastating to our position. So, what the Roth proposal would do is to try to get at the tax differential—the tax disadvantage. Isn't that right?

Mr. MEAGHER. Yes, sir.

Senator LONG. All other things being equal, you are absolutely against those three killers. If one doesn't get you, another one will.

If the first one doesn't get you, the second one will get you. And just in case that hasn't got you the dollar differential is guaranteed to get you. So, you take that and add it up, and they you are dead. You are gone, trying to compete. What the Roth proposal does is to try to equalize the tax differential between their taxing system and ours. That is basically what we are talking about. Now, we wouldn't have that problem on the tax point if those idiots hadn't gone to Geneva and given that away many years ago. [Laughter.]

That is true. They signed up on that general agreement on tariff and trade; and they said that those people could use those value added taxes and give the money back and charge it to us when they came to our market. So, they get the money back. It is just heading from their country to our country and being subsidized. Give the tax money back, and that is just the way they tax it. So, they get you either way. You can't invade their market and you can't defend your own. Now, all this would do is just let them enjoy some of the same burdens that we share over here when they come into our markets. And as far as the so-called regressive aspect of it is concerned, it is no more regressive than a Social Security tax, not nearly as regressive as a Social Security tax, to the extent that a Social Security tax fails to be a tax on consumption, to the extent that you can't pass it through in the price of a product. It becomes a tax on the worker, the person that earns the money, whose salary is taxed, or the corporation; but mainly, it is a tax on the worker to the extent that it is not a tax on consumption. And that aspect of it is horribly regressive. There is nothing in the tax law—certainly a value added tax can't be nearly as regressive as that—but even so, it can well be justified because that money is being used to pay for a progressive benefit. In other words, the people at the lower end of the scale get so much more back than they pay out that it is still a big advantage to them on the overall. So, if you put the spending aspect in there with it, the result then becomes progressive. And I will ask Mr. Meagher: Isn't that correct?

Mr. MEAGHER. That is my impression, Senator. What you in fact can do with this new tax is to make other necessary changes in the Tax Code, in the individual Tax Code, to make it less regressive, although it seems that Congress in recent years has done a great deal in that regard already to remove people from tax burdens that are of lower income. If it is desirable to do that further, obviously you can tinker with that and you will have the money to do that. But it is clearly not any more regressive, and probably not as regressive, as the FICA tax is.

Senator LONG. We already have a negative income tax in the earned income credit. Are you familiar with that?

Mr. MEAGHER. Yes, sir. Right.

Senator LONG. Lester Thoreau makes this point. Incidentally, I saw one of our Democratic Senators in the audience when Mr. Thoreau was speaking. He brought up the fact that a value-added tax was regressive. And he explained this point, and the Senator changed his mind within 60 seconds after Mr. Thoreau explained it. He said, look, you should couple that with a negative income tax, just as we do with the Social Security tax so that, to the extent that a person is not making enough money, let's say, to pay his

income tax, by way of the earned income credit you get him back—the money he paid in Social Security taxes. And Mr. Thoreau contends that you ought to do the same thing with a negative income tax to give those who are paying a value-added tax their money back if they are in the low income aspect of it; and there is no reason you can't do that. Is there?

Mr. MEAGHER. No, sir.

Senator LONG. So, one should not focus on the individual tax and ignore the mix. In other words, it is the sum total that you are paying that you have to look at. And if one aspect of it tends to be somewhat regressive, but the total mix is very progressive, particularly when you couple it with what you are doing with the money, you can find that the value-added tax is well justified, where it wouldn't be otherwise.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Gentlemen, Senator Long suggested that, from the point of view of the American competitive position, there are several major factors to be considered. One is the dollar; second is the low wage rates overseas; and third, a different tax system. I am wondering if you could, just at a gut level, quantify the degree to which our adverse competitive position is attributable to our different tax system. Just a rough estimate. How much of the problem is due to our different tax system?

Mr. MILLER. We have estimated in the past that, in the car business, the differential in the tax system is worth about $600 per car of unequal treatment. That doesn't count the approximately $1,700 per car revenues that are lost to the American tax system when a car is built overseas. I am just talking about the $600 tax differential that we have come up with in past studies, where we are disadvantaged to the foreign producers because of our unequal tax system.

Senator BAUCUS. Can any of you give me a rough sense, though, of whether the tax system is about a third of the problem, among those three answers?

Mr. MILLER. Yes.

Senator BAUCUS. Does the rest of the panel agree that about a third of the problem—more than a third, less than a third?

Mr. MEAGHER. Everybody says that the dollar is 50 percent of the problem. You can divide up the other two any way you want.

Senator BAUCUS. How do you divide it?

Mr. MEAGHER. I don't have any calculations or any numbers on that. What I do have is some estimates that we have done of the differential between the tax systems, depending on the country. It changes costs to the extent of 20 to 40 percent, and I don't know how you translate that. I am not a macroeconomic person having those figures, but if you translate that, in some way—I suppose people like my colleague here might be able to do that—that you might be able to come up with a number. I would obviously say it is significant.

Senator BAUCUS. Can you help us out?

Mr. SCHUYLER. I think in the short run changes in the dollar's value can have perhaps the largest of the three effects. In the long run, our tax structure is likely to have a profound effect. This is because the tax system will have a cumulative impact on our cap-

ital stock, both its quantity and its quality, producing eventually very large differentials in our productivity and our ability to price against foreign competitors.

Senator BAUCUS. Mr. Mack.

Mr. MACK. I don't have a comment on the calculations.

Senator BAUCUS. Let's assume we focus now on the differential in the tax systems, and let's assume further we are going to raise the same revenue that we raise today roughly. What percent of the revenue raised should—the Federal revenue raised—should be business transfer tax, consumption tax, and other taxes? And what I am getting at is: Should we go 10 percent of the way, 50 percent, 75 percent, in order to achieve a maximum American competitive position? It is somewhat the same question that Senator Danforth asked, that is, how far should we go? Our optimum goal is to enhance America's competitive position and to raise the same amount of revenue. Just rough, gut sense—how much of our present tax system should be replaced by this kind of a system?

Mr. SCHUYLER. May I give a two-part answer? If our only concern were American competitiveness and nothing else whatsoever, I would say 100 percent. Given our other concerns, probably around 20 to 25, then we would have a good mix of taxes.

Mr. MEAGHER. I think that you need to raise—again, not being a revenue estimator—but I think you need to raise a significant amount of money from this thing for a reason other than what is suggested; and that is that, if it is in fact a trade measure, and if you are in fact going to deal with the economics of trade and have it meaningful—in other words, simply not absorbed by foreign producers—it must be at the 10 to 15 percent level dpending on whether there are offsets as we suggest. If there are offsets, you are going to have to make it higher. We have a proposal, for example, that would allow a business minimum tax—alternative tax—combined with the BTT, and we think that that has to be in the neighborhood of 20 percent.

Mr. MILLER. I would just like to add that Chrysler's position is that S. 1102 with the basic 5-percent business transfer tax with the FICA offset was an ideal starting place. Basically, it would be noninflationary because there would be no net added cost to the production of American goods. Once you get past about 7 percent, we would lose our ability to do complete FICA offsets; and above the 7-percent rate, it becomes inflationary as general value-added taxes are. So, again, the genius of Senator Roth's proposal at 5 percent with its noninflationary feature—we thought that was a very good starting point.

Senator BAUCUS. Thank you.

The CHAIRMAN. Any other questions?

Senator Roth.

Senator ROTH. I do want to underscore one aspect which hasn't been touched on, and that is the importance, at least in my judgment, of savings. It seems to me that too little attention has been paid to that aspect of the problem. Senator Long, I think, very correctly pointed out the success of American technology, but it is very easy to have that exported—either exported by American business or, as my Japanese business friends will tell me, they use the Japanese individual savings or low capital to come over and

buy the best technologies. Now, I think it is important as one aspect of this problem of trying to make ourselves competitive that we offset the double taxation of savings, and that we do something to try to move the American people in the opposite direction. Now, I understand that you are not going to change patterns overnight, that it takes time; but I think it is important to understand that the Japanese were not always a savings nation. That has developed since World War II with the tax incentives that they have in their system. And I would just like to ask you, Mr. Schuyler and anybody else that may care to comment on it, one of our proposals is to build on the IRA's, not only for retirement but to let the people save for whatever reason because it is good for them as individuals, but it is also important as a new source of continuing source of capital. Would you care to comment?

Mr. SCHUYLER. I would say that your tax-deferred savings accounts are an excellent idea. They would be a successful way, up to the proposed accounts' yearly limits, to protect people from the double taxation—in fact more than double taxation—multiple taxation of saving that is characteristic of an income tax system. I think, in addition to simply changing the incentives, it would lead to a change in people's fundamental attitudes. It is the way to move to a high-savings society such as Japan's. Certainly, in the United States in the past decade, it turned out to be the borrowers who were smart people and the savers who were stupid. We want to change that around, and I think your tax-deferred accounts are a very positive step in that direction. I would applaud them.

Senator ROTH. Would anybody else care to comment?

Mr. MEAGHER. As I said, at our company we have a very modern employee benefits plan, which includes a cafeteria plan that works very well, and a 401K plan and an IRA and a very modern range of mix. The numbers on our 401K, which is a similar kind of device that would obviously be available outside companies, are numbers that are not only very much better for low-income people—in other words, they save—but they are across the board. There is no question that anybody who understands them, and obviously the financial institutions that will be making them available will make them understood very readily in very simple terms—it is a tremendous inducement to savings; and we have seen that just in my own personal situation in our corporation. It is a major incentive, and the results speak for themselves as to what you get from it.

Mr. MACK. Senator, I think that your question points up the need to go to something like a BTT in the context of the tax-reform package because, if you don't, you are inevitably going to lead to the kind of result that they have over in the Ways and Means Committee where they are either going to severely limit 401K's and other kinds of savings programs—and in the case of trade associations, they would take them away altogether. We have kids in our printshop who never saved before in their lives who are now saving through our 401K plan, which would be eliminated under both the administration and the Ways and Means proposals. Unless you do something like your proposal and look to a new revenue source, inevitably you are going to lead to those kinds of results, whether you are talking about savings plans, or whether you

are talking about eliminating capital cost recovery provisions, because you can't get the money any other way.

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate it. Next, we will move to a panel of Bob Warren, Louis Kelso, and John Houston. We will wait just a moment until the room clears out and quiets down. I want to introduce Bob Warren to the committee. Bob is a man I have known for almost 30 years. I have known his family and children very well and now—how many?—grandchildren?

Mr. WARREN. Eight grandchildren, eight as of the day before yesterday.

The CHAIRMAN. Mr. Warren is one of the most, if not the most, innovative businessmen I have ever met in this country. Mr. Warren manages to stay on the cutting edge and half a step ahead of his world competitors, to say nothing of his American competitors. Bob, we are delighted to have you with us.

## STATEMENT OF ROBERT C. WARREN, CHAIRMAN OF THE BOARD, CASCADE CORP., PORTLAND, OR

Mr. WARREN. Thank you, Mr. Chairman. I appreciate those words. Mr. Chairman and members of the committee, I am Robert C. Warren, chairman of Cascade Corp., headquartered in Portland, OR. I am here today solely on behalf of myself and my company. I do not represent any association or organization. I am sure that is rather unique. My testimony today will be directed to two areas of the administration's tax proposals only. I will not comment on the BTT, which I find very interesting, but which I am not that familiar with. My company's primary products are materials handling devices, known as attachments, which are used on forklift trucks throughout the world. We are a relatively small company, with annual sales of approximately $85 million, yet we are the largest supplier of our products in the world. We manufacture our products in four plants in the United States, four plants in Europe, one in England and three in Holland, and one plant in Japan. In addition, we have fully staffed sales and distribution centers in a total of 11 countries. Our foreign operations historically contribute 35 to 40 percent of our total annual sales, but it is extremely important that you members of this committee understand that our European and Japanese plants supply only their own markets. We import none of their production into the United States, yet our U.S. plants export about 15 percent of their production to our overseas subsidiaries. So, we are very much a net exporter. I emphasize this because it is very germane to the central idea I intend to present to you this morning. Cascade Corp. is totally committed to being a world-class player and to continue producing their U.S. requirements in the United States, rather than transferring this production to our overseas foreign locations; and this would be very easy for us to do when we have plants and organizations already in place.

During the past 5 years, we have invested heavily in the most advanced computer control machine tools and robotics here in the United States, to the extent of $16 million during a period which

included a very severe recession where our total U.S. earnings were only $20 million. So, needless to say, the investment tax credits and the accelerated cash recovery system were very, very important to us in this modernization program. Frankly, we could not have done it without those two. I simply want to say that, if advanced machine tools are available to our competitors and our foreign competitors, they have to be available to us; or we will simply perish. I am here today to suggest to you that the complete elimination of the ITC and ACRS as proposed would constitute an enormous mistake for this country. Even if the administration's new tax proposals are adopted, then there should come into being a 13 percentage point corporate tax reduction.

A significant segment of American industry is still going to need the advantages of ITC and ACRS. These other companies such as ours that are competing every day of their lives against heavily Government subsidized foreign companies in order to preserve our domestic and foreign markets. Survival of these industries is critical. America itself will not long survive as a major world power if these industries and skills are lost and we become dependent on foreign sources for all of these essential products. Far from suggesting that the ITC and ACRS be applicable to the broad range of investments it encompasses today, my first premise is that they should apply only to machinery and equipment manufactured in the United States.

Second, that only those items that are significantly impacted by foreign competition be included in any listing of qualified products. The investment tax credits and later ACRS were brought into being to stimulate investment and thus create jobs in our economy. When a substantial portion of these credits and benefits are allowed for investments in foreign-built machinery, it greatly nullifies the very intent of our laws. The program I suggest would correct this inequity. The other benefit of such a program, and it is a major one, is that it would give U.S. manufactured products about a 12- to 14-percent advantage against foreign competition because, obviously, the purchaser would not be allowed the benefits of the investment tax credit and ACRS on foreign equipment purchased. What this limited extension of these two would amount to in terms of lost revenue to the Treasury plan, I simply do not know; but it would certainly be substantially smaller than today's impact, and it could be the survival factor to many of our critical industries. We must give the companies that are endeavoring, like ourselves, to become world class competitors and who are trying not to move their production overseas the tax incentives to succeed. If this requires a smaller reduction than the proposed 13 percent in basic corporation tax rates, then this should be considered. I am well aware at the present that many of you, and perhaps all of you, are anxious to avoid raising protective tariff barriers and quotas and restrictions on foreign imports. I share that concern. What I am proposing is modest tax assistance indeed, compared to what we, as a company, have actually received or been offered and what we see being given to others in all of the countries where we operate and sell our products.

Another company in which I am involved recently negotiated a long-term commitment with a major European country that illus-

trates the magnitude of the tax incentives being granted to induce companies to invest. This particular country has a current statutory corporate tax rate of 43 percent, yet their Parliament just passed special legislation limiting this particular company's total tax for the next 5 years to one percent, and further than that, guaranteed that it will not exceed 13 percent in the next 10 years following that. I need not comment on the competitive advantage this provides. It is ironic that the Japanese Government is right at this moment finalizing a new 7 percent investment tax credit program, which is in addition to all of the numerous other and diverse incentives they offer their industrial sector, just at the time when our Government is considering abandoning it. Japanese firms will receive this credit on a cost of new equipment, provided it falls into one of 126 categories. We can be certain that this list will contain all the machinery and equipment necessary for Japan to enhance its position as one of the leading industrial nations in the world and that will make them not dependent on foreign sources. Investment alone does not assure the building of a world-class company, but none of the other things we have to do have any meaning unless our costs are competitive. Much of American industry today truly stands at a crossroads for which there may be no return, if we choose the wrong direction. If the dollar remains even near the level of the past 2 years, the U.S. manufacturing base will deteriorate badly; but even if the dollar declines to a more reasonable level, we will continue to face tougher and more effective competition as foreign technical capability is increased. We in industry can provide the investment, the ingenuity, the vitality to survive, providing you in Government supply an economic tax climate that will allow us to stay in the game. But don't move too fast. Don't panic. Thank you, gentlemen. I appreciate this opportunity.

The CHAIRMAN. Thank you very much, Bob.

Senator LONG. Mr. Chairman, I see a dear old friend of mine, Mr. Louis Kelso, is here today. He is the man who first got me interested in employee stock ownership; and as you can see, he is still interested in that sort of thing. And we are happy to welcome him here today to this committee.

The CHAIRMAN. Mr. Kelso, we are well familiar with what you have meant to the employee stock option plans in this country.

Mr. KELSO. Thank you, Mr. Chairman.

The CHAIRMAN. It is good to have you with us.

[The prepared written statement of Mr. Warren follows:]

* Portland, Oregon
Roseburg, Oregon
Springfield, Ohio
Warner Robins, Georgia
Toronto, Canada
Almere, The Netherlands
Almelo, The Netherlands
Diemen, The Netherlands
Hoorn, The Netherlands
Monchengladbach, W. Germany
Paris, France
Barcelona, Spain
Helsingborg, Sweden
Cramlington, England
Sheffield, England
Johannesburg, South Africa
Auklland, New Zealand
Sydney, Australia
Osaka, Japan

Manufacturers of
lift truck attachments and
hydraulic cylinders.

cascade® corporation
CORPORATE HEADQUARTERS:
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STATEMENT OF ROBERT C. WARREN

CHAIRMAN OF THE BOARD, CASCADE CORPORATION

BEFORE THE

SENATE FINANCE COMMITTEE

ON THE PRESIDENT'S TAX REFORM PROPOSAL

OCTOBER 10, 1985

cascade corporation

Mr. Chairman, Members of the Committee, Ladies and Gentlemen. I am Robert C. Warren, Chairman of Cascade Corporation, Headquartered in Portland, Oregon and I appear here today solely on behalf of myself and my Company, I do not represent any other Organization or Association.

My Company's primary products are Materials Handling Devices known as "Attachments", which are used on fork lift trucks throughout the World for the transport and storage of such commodities as Pulp and Paper, Packaged and Processed Foods, Appliances, Soft Goods, Tobacco, Textiles, Beverages, - - - the list is almost endless. These Attachments eliminate the need for conventional pallets normally associated with lift truck operation and thus provide substantial cost reductions in the process of transporting, warehousing and the handling of goods from manufacturers to the final consumers.

We are a relatively small company with annual sales of approximately $85 million dollars; yet we are the largest supplier of our types of products in every one of our markets around the World with the exception of Japan. Our competition in Japan consists of the lift truck manufacturers themselves, such as Toyota, Nissan, Mitsubishi and Komatsu, but we continue to make reasonable inroads into that market. We manufacture our products in four Plants in the United States, four Plants in Europe, including one in England and three in Holland, and one Plant in Japan.

Our company has been heavily involved in overseas markets since 1959 when we built our first European Plant, and we currently have fully staffed Sales and Distribution Centers in a total of 11 countries. Our foreign operations

historically contribute 35 to 40% of our total annual sales, and it is important for you to understand that our European and Japanese Plants supply only their own markets. We import virtually none of their production into the U.S. with the exception of two models which have very limited demand in this Country. Conversely however, our U.S.Plants export about 15% of their production in the form of finished products and components to our overseas subsidiaries, so we are very much a net exporter.

I emphasize this because it is very germane to the ideas I intend to present to you this morning. Cascade Corporation is totally committed to being a "World Class" player and to continue producing our U.S. requirements in the United States rather than transferring this production to foreign locations as so many machinery manufacturers have felt compelled to do in the last few years, and which it would be so easy for us to do with diverse foreign manufacturing plants and organizations already in place.

During the past five years, 1980 thru 1984, we have invested heavily in the most advanced computer controlled machine tools, robotic welding, and computer aided design and manufacturing procedures (Cad-Cam) even through the very severe recession of 1982-83. During this period we invested over 16 million dollars in machinery and equipment in our U.S. Plants alone; compared with total U.S. earnings for that period of only 20 million dollars. Needless to say, the Investment Tax Credits (ITC) and the Accelerated Cash Recovery System (ACRS) provisions in the current tax laws were critical to us in acquiring these advanced tools. Without them our moderization program would, of necessity, have been substantially less and our posture today equally less competitive.

As we must continue to invest in automated equipment at an even greater pace as each year passes, our first concern in reading the Treasury Department's new tax proposals, which would eliminate the ITC entirely and replace ACRS with a system that involves much longer recovery periods, was to determine how these proposals would effect our future investment programs. You will be interested to know that had the new Treasury program been in effect over the same five year period, 1980 thru 1984, we would have paid slightly less Federal Taxes, but basing any conclusions on just this alone would be very misleading. Under the present ACRS provisions our machinery and equipment would be fully depreciated at the end of this period and our cash reserves built up to enable us to buy new and even more advanced tools. I cannot over emphasize the importance of this because most of these highly automated tools are literally obsolete in about 5 years time due to technical improvements that are escalating at an ever increasing pace. The real significance of keeping abreast with "State of the Art" manufacturing technologies can best be illustrated in terms of our Worldwide employment levels during the last 5 years. Total employment dropped from 1220 people in 1980 to 860 people at the end of 1984, an overall decrease of 30% during a time when we increased our Engineering and Sales staffs and increased the unit volume of products produced. If this advanced machinery is available to our foreign competitors it must be available to us, or we will perish.

I am here today to suggest to you that the complete elimination of ITC and ACRS, as proposed, would constitute an enormous mistake. Even if the Administration new tax proposals are adopted and there comes into being a 13% tax reduction for Corporations, from 46% to 33%, and partial dividend deductability, a significant segment of American Industry is still going to need the advantages of ITC and ACRS. These are the companies, such as ours, that

must compete every day of their lives against heavily government subsidized foreign companies in order to preserve our domestic and export markets. The survival of these industries is critical! America simply cannot survive as a major world power if these industries and skills are lost, and we become dependent on foreign sources for all of these vital products.

I am not suggesting that ITC and ACRS be applicable to the broad range of investments it encompasses today. My first premise is that they apply only to machinery and equipment manufactured in the United States, and secondly that only those industrial and commercial machinery items that are significantly impacted by foreign competition be included in any listing of qualified Products. In determining that products are in fact manufactured in the U.S.,the builder would have to certify that they contained at least the minimum U.S. content specified in the Legislation.

ITC then later, ACRS, were brought into being to stimulate investment and thus create jobs in our economy. When a substantial portion of these credits and benefits are allowed for investments in foreign built machinery it greatly nullifies the very purpose of these laws. The program I suggest would correct this inequity. The other benefit of such a program, and it is a major one, is that it would give U.S. manufactured products about a 12 to 14% advantage against foreign competition because obviously the purchaser would not be allowed the benefits of ITC and ACRS on any foreign equipment purchased.

What this limited extension of ITC and ACRS would amount to in terms of lost revenue to the Treasury plan I cannot begin to estimate, but it would certainly be substantially smaller than todays impact, and it could be the survival factor

for many of our critical industries. We must give the companies that are endeavoring to become "World Class" competitors here in the United States, and who are trying not to move their production overseas, the tax incentives to succeed. If this requires a somewhat smaller reduction than the proposed 13% in basic corporation tax rates, then this should to considered.

It is interesting to note that the proposed Treasury plan would not have impacted our company over the 1980-84 period much differently than the present tax law, including ITC and ACRS, but only because we took advantage of these incentives and actually made the investments. The Treasury plan includes no such inducements to modernize. Companies would simply end up with more after tax earnings to dispose of as they pleased.

I am well aware that the President and many of you, perhaps all of you, are anxious to avoid raising protective tariff barriers and imposing quotas or other restrictions on foreign imports that could start a retaliatory trade war and negate the years of effort that we and our trading partners have put into G.A.T.T. I share that concern. What I am proposing is modest tax assistance indeed compared to what we as a company have actually received, what we have been offered, and what we see being given to others by most of the countries where we operate and sell our products. Tax subsidies, whether we like them or not, have become a way of life in the World marketplace and they are on the increase. Another company in which I am involved, recently negotiated a long term commitment with a major European country that illustrates the magnitude of the tax incentives being granted to induce companies to invest, provide employment opportunities and create export foreign exchange. This particular country has a current statutory corporate tax rate of 43%, yet their Parliament passed special legislation limiting this particular company's total

tax rate to 1% for the 1st 5 years of operation, and a maximum of 13% over the ensuing 10 years. I need not comment on the competitive advantages this provides.

It is ironic that the Japanese Government is right at this moment finalizing a new 7% investment tax credit program, in addition to all of the numerous other and diverse incentives they offer their industrial sector, just at the time when our Government is considering abandoning it. Japanese firms will receive this credit on the cost of new equipment provided it falls into one of 126 categories designated as "High Tech". We can be certain that this list will contain all of the machinery and equipment necessary for Japan to enhance it's position as one of the leading industrial nations of the World and not make them dependent on foreign sources. I do not know whether their new law will restrict these credits to Japanese built products, but from our 14 years of experience of operating in Japan we are certain that there will be little or no foreign equipment purchased, regardless of their recent public utterances.

I have talked at length about the importance of ITC and ACRS. I have not referred to that portion of the Treasury's tax proposals which is the imposition of a retroactive tax on ACRS deductions taken in prior years. To penalize those companies now, who in good faith did exactly as the laws encouraged them to do, shows such a total lack of understanding of the competitive problems America faces in the real world as to be truly frightening.

I want to state very clearly that investment alone does not assure the building of a "World Class" company. Total employee participation and cooperation, continuous investment in research and development, advanced designs for the marketplace, and absolute quality control are equal factors. However, none of these can be effective without competitive costs that only investment in the most

modern tools of production can achieve.

Although it is extraneous to my tax testimony here this morning, it might interest you to know that over the period of the past three to four years we have changed the attitudes of our management, and the operating philosophy of our company and our plants, almost 180°. We have involved our entire work force in understanding and helping solve our world competitive problems and they are responding extremely well. In the last 2 years alone, we have improved productivity in each of our four U.S. plants, by a minimum of 28% to as high as 70%. To accomplish this meant the elimination of virtually all of the restrictive work rules and practices that had accumulated over the years, and putting our employees on direct financial incentive programs, over and above their regular hourly wages or salaries, which enable them to share equally in all productivity gains. This incentive is paid to them in cash on a monthly basis and is very substantial.

We have also converted three out of our four U.S. Plants to an "all salaried workforce" whereby we no longer have hourly paid workers. The factory personnel in these plants enjoy the same health, vacation and retirement benefits as the office and supervisory employees and undergo the same annual salary and performance reviews. Nor are they penalized for time lost for legitimate reasons. This has been done in a major effort to eliminate the "we" and "they" attitudes that have existed between labor and management for so long. We obviously do not have a lengthly record of operating our plants in this manner, but so far it is very encouraging.

Gentlemen, I wish to thank you for according me the privilege of appearing before you here today. If you have any questions I will be very happy to try to answer them for you.

## STATEMENT OF LOUIS O. KELSO, PARTNER, KELSO & CO., SAN FRANCISCO, CA

Mr. KELSO. Thank you, Mr. Chairman. I come before you today to ask you to shift your attention from taxation to economic policy. The United States has an economic policy, the Employment Act of 1946, which was in fact policy a century before it was formalized in that law; but it is a policy that says, asserts, that since this is a market economy, of course, everyone must earn their income by participation in production. Unfortunately, it goes further and also asserts that the only way to do that is to work.

Now, this policy in my opinion is responsible for the great bulk of tax turmoil. It is responsible for the problem which Senator Howard Baker referred to in a very interesting article in the New York Times about a year before he left the Senate, in which he deplored the fact that the Senate—and Congress as a whole—had become an elected bureaucracy. It has become an elected bureaucracy redistributing other people's money, which is a very ignaminious thing to do, to the extent that it is not necessary.

Back in the 1920's, the American economic system collapsed; and it collapsed for reasons that I don't think you can understand without understanding two factor economics. It collapsed because the enormous concentration of productive power in the tiny minority of owners of capital, and because the earning power of the masses who didn't own capital was insufficient to support production. Under the principles of a market economy, as Adam Smith so aptly defined them, consumption must support production, just as production has to support consumption. So, the economy fell flat on its face.

In 1932 we were rescued, I think—I lived through those times—from what could have been a second Civil War. The New Deal was a bold and dramatic thing, but the destiny which President Roosevelt hailed in 1933 when he said "America has a rendezvous with destiny" was the wrong destiny. The New Deal declared a war on the effects—not the cause—the effects of poverty. We began taxing and spending and redistributing other people's money, and that is the thing that is taking up your time and your attention, and causing the national debt to grow through annual deficits.

Let me point to something. Nature got into this business of economic policy long before Congress did, and nature designed man to be economically autonomous. For each consumer, there was born a producer, right in his person, in his body—his arms, his legs, his mind. Nature thought economic autonomy was a good plan. Each family should produce the equivalent of what it consumes. Now, the industrial revolution came along; and I urge you to take a look at the diagrams, if you will, in my written testimony on page 11. There is a moving curve that moves through society, through business, through human activity, which changes the way in which goods and services are produced from labor intensive to capital-intensive. What we have in this country is a technique of finance which makes capital acquisition available to well-capitalized people and denies it to the uncapitalized people. In other words, we have a technology which raises the earning power of the affluent and even those who have earning power thousands of times what they can

consume, and denies incremental earning power to the 95 percent of the people in the economy who don't own capital to begin with.

The end result is that Congress must make up the difference through redistribution. In 1932, we began digging welfare canals around the property system. Those welfare canals are now being closed up because people revolt against welfare. The answer is to change the economic policy to recognize that capital workers, people who participate in production and earn income through their capital, are just as much participants in production, just as validly and legitimately engaged in production as labor workers, and capital in general is far more powerful than labor.

So, that little correction of the factual error in economic policy can lay the background for things like the ESOP, which Senator Long introduced into the law and made possible. It is a technique for making capital credit available to people who otherwise wouldn't have it, and enabling them, without taking anything out of their pockets or paychecks, to become capital workers. Lifetime full employment—American style is the economic policy indicated by that.

The ESOP is one of eight tools. The other seven have been sitting there waiting to be implemented. I urge your attention to that to solve the tax problems and many, many other basic problems.

Senator SYMMS. Thank you very much, Mr. Kelso.

Mr. Houston.

[The prepared written statement of Mr. Kelso follows:]

HEARING BEFORE THE

SENATE FINANCE COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS - FIRST SESSION

WASHINGTON, D.C.

# ALTERNATIVE TAX PROPOSALS

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MEMORANDUM BY LOUIS O. KELSO

OCTOBER 10, 1985

## THE PROPONENTS

Louis O. Kelso is an economist, author, lawyer, and investment banker, who has devoted most of his professional life to exposition of the logic of democratizing the American capitalist system so that it will work for the many, not just for the plutocratic few, and to developing the financing techniques for accomplishing the structural reforms necessary to broaden the capital ownership base, and to raise the capital-sourced earning power of the presently capitalless majority of families.

The best known of his eight basic reform strategies for accomplishing this, each which uses the same financing logic, is the Employee Stock Ownership Plan (ESOP), towards the perfection of which Congress, between 1973 and 1985 has enacted some twenty laws.

Mr. Kelso is one of the founders of the ESOP Association of American, a non-profit trade association of corporations that have installed ESOPs in their corporate structures, which has four hundred member companies doing business in all but eight states of the union, and four hundred professional members. Its member companies are estimated to have over one million employee-stockholder ESOP participants, out of an estimated ten million employees in the United States covered by employee stock plans of various kinds. It is located at 1725 DeSales Street, NW, Suite 400, Washington, DC 20036; (202) 293-2971.

Mr. Kelso was assisted in the preparation of this memorandum by his wife and coauthor, Patricia Hetter Kelso and by Joseph Schuchert, Managing Partner of Kelso & Company. Kelso & Company is headquartered at 350 Park Avenue, New York, New York, 10022; (212)751-3939, and has offices in Newport Beach, California, and in San Francisco, where Kelso lives.

## TAX REDUCTION THROUGH FULL EMPLOYMENT - AMERICAN STYLE

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The fiscal ailments confronting the American economy - rising permanent debt and annual deficits, high taxes, stunted economic growth, shrinking international economic stature, spiraling trade deficits, etc. - are direct consequences of our massive underemployment, and that, in turn, is an inevitable result of an anachronistic - indeed a Stone Age - National Economic Policy (NEP).

Our recommendation to Congress, made in lieu of any proposals for tax reform other than loophole closing, is that it correct the manifest and embarrassing factual error in the NEP, and that Congress then set about implementing the new and realistic policy.

These are the highlights of our underlying reasoning:

- Well over half of all taxes collected by government in the United States — 55% for the federal government and 60% for the state governments — are levied on people who earn income, to take away part of their income in order to give it to people who need more income, or who have no other source of income whatsoever.

- The support provided by Congressional redistribution of income from people who earn it to people who need it or need more of it is not limited to the funding of "transfer payments," massive as they are.

  — By legislation adopted from time to time since 1932 Congress, generally with the active help and cooperation of labor unions, has rigged the price of labor in order to accord working people progressively more pay for progressively less work, thus converting the private sector, to a large degree, into a welfare machine disguised as business. This redistribution is paid for by consumers; by rising foreign trade deficits as we price our goods and services out of the international markets; and by additional taxes, rising national debt and rising annual deficits, required to fund the activities of business' largest customer: the United States Government.

  — Taxes levied, or incremental governmental deficits incurred, to finance various expenditures, including the staggering increases in the stockpiles of useless war goods purchased with admitted awareness that they cannot be used: "deterrents" aimed, in reality, at unemployment, rather than any international enemy.

  — These last two items rival in magnitude the admitted transfer payments. They are exacerbated year after year by massive increases in government debt service.

- The real flaw in the economic "system", if an economic plan so out of touch with reality can be called a "system", does not lie in the tax laws, though they contain some shocking loopholes, but in the National Economic Policy. The evil consequences of the unrealistic NEP began, of course, long before it was formalized into the (Full) Employment Act in 1946.

**WHAT IS THE DEFECT IN THE NATIONAL ECONOMIC POLICY?**

Long before it was formalized into law in 1946, we lived by and operated the economy on an erroneous economic policy; one asserting that the only way for individuals to participate in production and to earn income in this private property, free market, capitalist economy — is to work.

Capital, meaning land, structures, machines and capital intangibles, normally owned through corporate common stock, was, and still is, treated like a catalytic agent. **Under the NEP, it makes no difference who owns the capital employed in the economy, so long as there is plenty of it!**

The owners of non-residential capital, a tiny 5% of the population in general, are treated as "trustees" of this catalytic agent, "trustees" selected by Providence for this

very important, powerful, and dignifying function. Many of them have so described their fortunate positions as owners of concentrated holdings of the thing that long before 1929 had become, quantitatively and qualitatively, the principal way to produce goods and services and to earn income.

The truth is that there are two ways, not just one, in which individuals in a private property, free market, capitalist economy legitimately may engage in production and earn income. They can employ, or have others employ, their privately owned labor power. But they can also employ, or have others employ, their privately owned capital, normally represented by capital stock, since most production is carried on in corporte form, and most capital assets are owned through corporations.

**Capital is not a "catalytic agent" in the production process. Owning capital is but one of the two ways, the other being the ownership of one's own labor power, through which individuals may engage in production and earn income.**

This simple reality confronts the **factual** error in the national economic policy: not only does it make a vast difference who owns the capital at work in the economy, but owning significant capital, with rare exceptions, is the difference between being poor and not poor; between being economically self sufficient under all circumstances, and living precariously; between earning part of your personal income in a way consistent with the state of the industrial arts and being wholly dependent upon the preindustrial method for doing so; between the possibility of lifetime employment and income earning, and the virtual certainty of penurious, precarious unemployment or retirement. The truth is that the **sole** reason for an individual being poor is that he does not own sufficient capital.

## SOME OF THE ECONOMIC CONSEQUENCES OF THE FACTUAL ERROR IN THE NEP?

Here are some of the principal consequences of maintaining and operating the economy on the basis of the a National Economic Policy that blatently misrepresents to all citizens the truth about the production of goods and services.

- Rising federal deficits and rising permanent federal debt
- Large and increasingly unrepayable foreign indebtedness to the U.S. and U.S. banks
- Rising federal and state taxes
- Rising trade deficits
- The decline of the United States' economy as the leading world economy
- The debasement of U.S. craftsmanship
- The spiraling concentration of personal capital ownership by the plutocratic minority
- The absence of personal capital ownership by the 95% majority
- The adversary strife between management and labor

- Rising alienation throughout the country, leading to narcotic use, terrorism, arson and what-not
- Labor unemployment, including unemployment concealed as boondoggle, which we estimate to account for about 30% of the presently "employed" labor force
- The decline in the quality of economic life in the United States in the last decade
- The continuation of an economic underclass within the country — people who simply cannot earn enough to live decent economic lives
- The inability to raise the earning power of people who would purchase far greater quantities of goods and services if they could but afford to do so, thus creating the powerful consumer markets that producers want and need
- Our diminishing status as a world creditor nation and our return to the status of a debtor nation
- The fact that our society is becoming increasingly uninsurable — a certain proof that business is slowly grinding to a halt

**WHEN DID THE FATEFUL ERROR IN THE NEP FIRST SURFACE?**

To answer this question, we need to go back, using hindsight again, for another look at one of the most important events in our economic and political history — The Great Depression. Before we do that, let's review:

**THE USE OF THE TAXING POWER IN A PRIVATE PROPERTY, FREE MARKET, CAPITALIST SOCIETY**

The purpose of taxation is, of course, to raise funds justly and fairly from all citizens of the country, to enable government to carry out efficiently and reliably, its proper functions.

But the proper governmental functions of the state in a private property, free market, capitalist economy do not include government's engaging in the production of goods and services, unless the economy fails to function properly, and they do not include the redistribution of income or wealth from those who earn more of it to those who earn less, or none at all, unless, again the institutions fostered by the state fail to fulfill the federal government's Constitutional obligation to enable all families to be economically autonomous and self-supporting.

— In the latter case, while the government may provide welfare as an expedient, its primary objective should be to restore economic self-sufficiency to the underproductive.

## THE STRATEGIC ERROR OF THE NEW DEAL

The strategic error upon which most of the economic reforms of the New Deal were based, notwithstanding that its name did not come into usage until the Johnson and Kennedy Administrations, was what we call "The War On Poverty". It is not and never was a war on poverty, but rather a **war on the effects of poverty.**

The "War On The Effects Of Poverty" reflects the incompleteness of our thinking about the cause of poverty — the same thought omission that gave us our unrealistic and increasingly unworkable National Economic Policy. To have avoided or corrected those errors, we should first have asked ourselves a simple, direct question: "Why are people poor?"

The answer to that question, when you finally discover it, is quite simple, stark, and irrefutable.

**PEOPLE ARE POOR BECAUSE THEY DO NOT OWN SUFFICIENT CAPITAL.**

No matter what other shortcoming or problems they may have, people who own viable capital holdings are not poor.

## THE GREAT DEPRESSION

The citizens of the United States ran this country for 150 years, from its founding until 1929, with some economic ups and downs, but generally in accordance with the economic game rules for a private property, free market, capitalist economy. But then, the economy broke down. Why?

The crash of 1929 was caused by the fact that a tiny minority of capital workers were producing most of the goods and services, and the capitalless majority of families — 95% of the consumers — could not earn income sufficient to purchase more than a fraction of the economy's output. The economy fell on its face.

It was on the occasion of that breakdown that the people and the government of the United States made the strategic wrong turn that changed Congress from a body of policy-making lawgivers, into, to use a phrase coined by Senator Howard Baker about a year before he left the Senate[1], an"assemblage of elected bureaucrats," primarily engaged in redistributing other people's income and wealth.

**"AMERICA HAS A RENDEZVOUS WITH DESTINY..."**

proclaimed Franklin D. Roosevelt in 1933 as he launched The New Deal.

But today, it is glaringly clear that the New Deal singled out and diligently pursued the wrong destiny.

The New Deal's failure to ask, and to discover, the **cause** of poverty, and instead its seeking ways to ameliorate the **effects** of poverty, led inevitably to the repudiation

(1) SAN FRANCISCO CHRONICLE, April 18, 1984, Page A-1, reprinted from NEW YORK TIMES MAGAZINE.

of the principles of private property, free market, capitalist economics, and embarked the nation on the ideologically alien socialist course of using the taxing, regulatory, and other powers of government to redistribute income from those who earn more to those who — in the opinion of Congress — need more.

Failure to identify the cause of poverty as insufficient capital ownership, led naturally to failure to redesign our business and economic institutions to make capital ownership grow where it is needed as capital input replaces labor input in production. The strategic error of the New Deal, which has been dogmatically followed by every administration and every Congress since 1932, was formalized into our official National Economic Policy — The (Full) Employment Act of 1946.

It is elementary that the duty to establish institutions that will efficiently, and in conformity with Constitutional safeguards, equip every citizen with capital ownership, as the way in which goods and services are produced changes from labor-intensive to capital-intensive, falls squarely on Congress.

Nature obviously designed Man for economic autonomy, and equipped each adult consumer with one labor power. Could Nature point the way any more clearly for our legislators to guide their structuring of the economy, as we progressively create more and more capital instruments to spare us toil, and to improve the quantity, quality, and variety of goods and services we produce?(1)

Unless the NEP is changed to recognize the facts of economic life — namely that there are two ways for individuals to participate in production and earn income — and the change is implemented, as it can easily be, the United States is committed to complete its capitalist extinction, exactly as socialist Karl Marx predicted.

## HOW MIGHT CONGRESS GO ABOUT CORRECTING THE ERROR?

The immensely important but erroneous National Economic Policy is set forth in a single paragraph in Section 1 of the Employment Act of 1946 (15 U.S.C. 1021). It refers to "employment" only in the conventional and historical senses of the word.

But that, of course, conflicts with the reality that an individual can participate in production and earn income not only by employing, or having others employ, his privately owned labor power, but also by employing, or having others employ, his privately owned capital.

Only about a dozen words in the Act need to be changed or reinterpreted to correct this all-important policy declaration. The words we would suggest are in dark type in the following paragraph that otherwise conforms to the present law:

### AMENDED DECLARATION OF POLICY

> Section 1. The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture **banking, finance,** labor, and

(1) See "The Right To Be Productive," Exhibit I hereto.

State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, **as labor workers and as capital workers, for all consumers desiring economic autonomy and self-sufficiency,** and to promote maximum employment **as labor workers, or as capital workers, or in both capacities, and maximum production and purchasing power.**

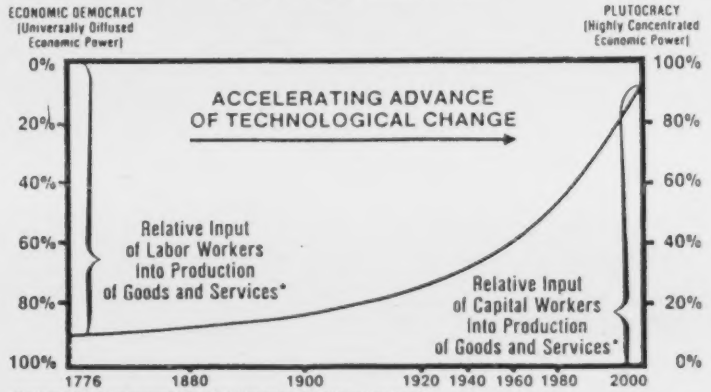
Every legislative draftsman has his own style. However, attached to this statement as Exhibit II is one possible version of a prologue to the corrected economic policy law if a formal law, rather than a mere interpretive resolution be thought best.

## IS THIS PROPOSED CORRECTION OF THE FACTUAL ERROR IN THE NATIONAL ECONOMIC POLICY TOO RADICAL FOR CONGRESS?

It would be well, in considering this question, to address the meaning of the words "work" and "employment". The current interpretation of the NEP (which incidently, is the national labor policy as well) is that only work or employment involving the use of the powers of one's body or of one's mind — human labor — is recognized as productive activity. That interpretation is diametrically contrary to the facts that, day after day, confront all people. An individual can, of course, engage in productive activity and earn income through employing, or having others employ his privately-owned labor power. But one can equally participate in production and earn income through employing, or having others employ, his privately-owned capital.

It is elementary that as the way in which goods and services are produced changes, through the ever-continuing industrial revolution, from labor intensive to capital intensive, the way in which people — not just some people but all people — engage in production and earn their incomes, should also change from labor intensive to capital intensive. The bounty of science and technology should not, and cannot, be reserved exclusively for the economic elite, the plutocrats.

### CHANGING PARTICIPATION of LABOR WORKERS and CAPITAL WORKERS in PRODUCTION of GOODS and SERVICES




*Estimated on the assumption that the value of productive inputs is measured in reasonably competitive markets.

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Failure to understand this simple reality, and failure to realize that we have the institutions, if we would but use them properly, to enable people without capital, to buy it, speedily pay for it, and thereafter to engage in production and earn income through their privately-owned capital, is a continuing cancer within our society. It has given both consumers and producers a century of various levels of self-imposed poverty, subdued production, depressed economic growth, misery and frustration. Obliviousness to these economic realities synthetically, unjustly and immorally divides Americans into two antagonistic camps: the non-productive "unemployed" and "retired" and the productive income earners, including both labor (service) workers and the tiny (5%) group of elite capital workers who own all the non-residential capital of the economy.

"Work" and "employment" are words that, rationally used, denote engaging in the production of goods and services either as labor workers, or as capital workers, or both, and earning income therefrom. It is nonsense for us not to recognize that if there are two ways in which each individual can engage in production and earn income, then in all economically-orientated discussions we must equally recognize as **work** both "labor work" and "capital work" that results in the production of useful and salable goods and services. And we must equally recognize "employment" as a labor worker and "employment" as a capital worker, and any pragmatically sound combination of the two, as **"employment."**

## LIFETIME EMPLOYMENT - AMERICAN STYLE

One of the obvious implications for "retirement income" discussion to arise from acknowledging that there are two ways to engage in production and earn income, rather than only one, is that if we operate our institutions sensibly and properly and in accordance with the American Constitution, people may, and indeed must, at the appropriate time, retire from the work-a-day labor world, **but that they should never retire from participation in production and earning income as capital workers.** Labor work, by its very nature, is not and should not be a life-long condition. Capital work should go on as long as life does, because human need for income continues to the end of life, and earning it legitimately in old age is just as important, both to the individuals and to the economy, as legitimately supporting oneself and one's dependents through earlier years. If we are to kick the socialist **divertissement** we have been mistakenly embarked on, and restore our economy to a private property, free market, democratized capitalism, then **Lifetime Employment — American Style** — should be the goal toward which all people should strive and all institutions be guided by government, business, and finance.(1)

It is time for Congress to take the lead and make this clear.

## IN ACTING UPON OUR PROPOSAL, CONGRESS WOULD BE BUT FOLLOWING THE RECOMMENDATION OF ITS OWN JOINT ECONOMIC COMMITTEE IN 1976

In its Annual Report to Congress in 1976, the Joint Economic Committee, under the Chairmanship of Senator Hubert Humphrey, made the following recommendation:

(1) This concept is further discussed in "How We Can Create Lifetime Employment," Exhibit III attached hereto.

**To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership.**(1)

## A PRECEDENT FOR CORRECTING THE FACTUAL ERROR IN THE NEP

There once was a very prominent man of his time, who was a firm believer in slavery, for the simple reason he thought some people needed slaves so they could gain freedom from unremitting subsistence toil in order to live human lives and to pursue the arts and sciences and the mysteries of life and the universe — to acquire and develop culture and civilization.

He did, however, have reservations about how to justly determine who should be owners and who should be slaves, a problem which he predicted would be solved if machines should be invented to take over most of the slaves' work.

This fellow was not a character out of yesterday's science fiction. He actually lived more than 20 centuries ago. His name was Aristotle.

He said that "If every instrument could accomplish its own work, obeying or anticipating the will of others... if the shuttle could weave and the plectrum touch the lyre without a hand to guide them, chief workmen would not want servants, nor masters slaves."(2)

Aristotle never indulged the speculation that if a country could bring into existence all the capital slaves (instruments) it might need, it would so operate its economy that a tiny minority would own them all and the majority of its citizens would be proletarianized, as Karl Marx later predicted.

## ONCE THE FACTUAL ERROR IN THE NATIONAL ECONOMIC POLICY IS CORRECTED, WHAT THEN?

William Blake, an English philosopher of nearly two centuries ago, well understood that merely announcing a new policy is not sufficient. He said:

**"He who would do good to another must do it in Minute Particulars. General Good is the plea of the scoundrel, hypocrite and flatterer, For Art and Science cannot exist but in minutely organized Particulars."**

So what is needed is a way for those not born with capital ownership and unable, through traditional means, to buy it and pay for it, to legitimately and efficiently acquire it.

(1) See Exhibit IV attached hereto.
(2) Politics, Book I, Chapter 4.

You are all familiar with the Employee Stock Ownership Plan — the ESOP. It is defined by Congress as a corporate financing device designed to build capital stock ownership broadly into employees of corporations, in ways that are mutually beneficial both to employers and employees.

We have developed eight financing strategies, all using the well market-tested logic of the hundreds of successfully operating ESOPs in the United States, capable in the aggregate of quickly and efficiently building viable capital estates into all American families. We estimate that most of the job could be accomplished in a decade; all of it could be done within two decades.

These capital financing methods are briefly outlined in two of the exhibits to this written statement:

Exhibit I - The Right To Be Productive
Exhibit III - How We Can Achieve Lifetime Employment

**BRIEF SUMMARY OF THE LOGIC OF THE ESOP AND OF THE SEVEN OTHER CAPITAL FINANCING STRATEGIES FOR IMPLEMENTING THE GOAL OF FULL EMPLOYMENT, AS CAPITAL WORKERS, OF THE 95% OF AMERICANS WHO OWN NO CAPITAL TODAY**

1. The logic of capital acquisitions, from the standpoint of the buyer is, and always was, self-liquidation of costs. Intelligent people acquire capital directly, or more commonly, through acquiring stock in a corporation that holds productive assets and engages in production, with the educated expectation that the capital will pay for itself within a reasonable period of years, normally three to five years.

2. After the capital has paid for itself, sound operating and maintenance procedures, proper economic restoration through accounting procedures, and with constant technological restoration through research and development procedures, all treated as normal operating expenses of the business, the capital will enable its owners to continue engaging in production and earning income indefinitely.

3. The most frequently-used and most logical means of financing capital acquisition is through the use of capital credit — credit extended by a bank or other loan source, to an entrepreneur or asset using corporation to buy capital.

4. The financing contracts normally provide that the wages (the yield) of the financed capital must be applied first to repayment of the interest and principal of the financing loan, before they can be used and enjoyed by the stockholder or other owner.

5. Of course, there is a risk that the yield of the newly-acquired capital might not fully pay off the full principal and interest of the financing loan, or might not be able to do so in the planned amortization period. That is the feasibility risk.

6. Such risks, like business risks in general, are handled through established insurance procedures. For reasons that can be accurately established, but which we cannot take time here to examine, the only kind of capital credit insurance normally available for acquiring capital is **self-insurance**, insurance provided by the enterpreneur or would-be capital user, or by someone else on his behalf, at a normally high equity-sharing price.

7. This self-insurance procedure has the effect of enabling the already well capitalized to acquire more capital, and of making it impossible for the uncapitalized — 95% of the population — to acquire capital ownership at all.

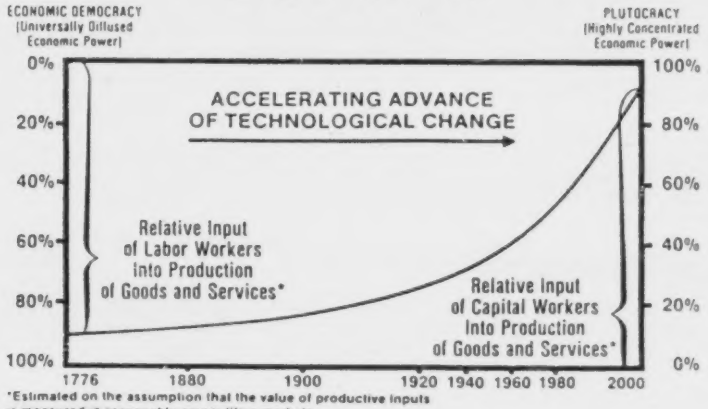
8. This is why, over the 209 years of the American Industrial Revolution, except for a period of about forty years following the first Homestead Acts in 1862, the ownership of all non-residential capital in the U.S. has been firmly lodged, and today is firmly lodged in the top wealthholding 5% of families. But the relative productive inputs of capital workers has changed, because the ever-accelerating industrial revolution, from about 5% of total productive input in Colonial times, to, I estimate, 90% of total productive input today. In the meanwhile, the productiveness of the capital at work in the economy has grown thousands of times over.

9. Naturally, the relative input of labor workers, if measured by hypothetical free market forces, has declined from 95% in Colonial days to 10%, or less today.

10. The economy functions, however, badly, through socialist redistribution on the basis of need, from those who earn more, to those who earn less or earn nothing — as Congress determines by constant bureaucractic administration!

The following diagrams illustrate the point.

## CHANGING PARTICIPATION of LABOR WORKERS and CAPITAL WORKERS in PRODUCTION of GOODS and SERVICES




*Estimated on the assumption that the value of productive inputs is measured in reasonably competitive markets.

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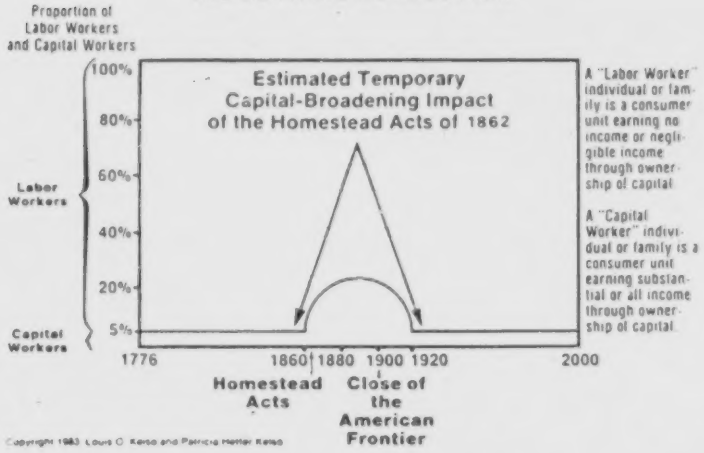
## THE CONCENTRATION of the OWNERSHIP of CAPITAL OVER the PERIOD of the INDUSTRIAL REVOLUTION


Proportion of Labor Workers and Capital Workers
100%
80%
60%
40%
20%
5%
Labor Workers
Capital Workers
Estimated Temporary Capital-Broadening Impact of the Homestead Acts of 1862
A "Labor Worker" individual or family is a consumer unit earning no income or negligible income through ownership of capital.
A "Capital Worker" individual or family is a consumer unit earning substantial or all income through ownership of capital.
1776
1860
1880
1900
1920
2000
Homestead Acts
Close of the American Frontier

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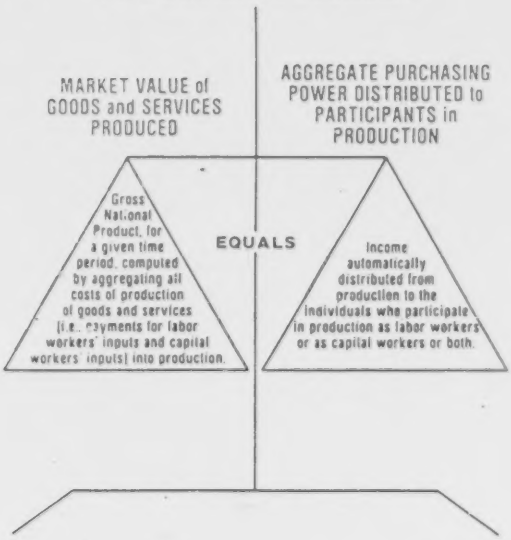
## SAY'S LAW AS APPLIED TO A NATIONAL ECONOMY


MARKET VALUE of GOODS and SERVICES PRODUCED
AGGREGATE PURCHASING POWER DISTRIBUTED to PARTICIPANTS in PRODUCTION
Gross National Product, for a given time period, computed by aggregating all costs of production of goods and services [i.e., payments for labor workers' inputs and capital workers' inputs] into production.
EQUALS
Income automatically distributed from production to the individuals who participate in production as labor workers or as capital workers or both.

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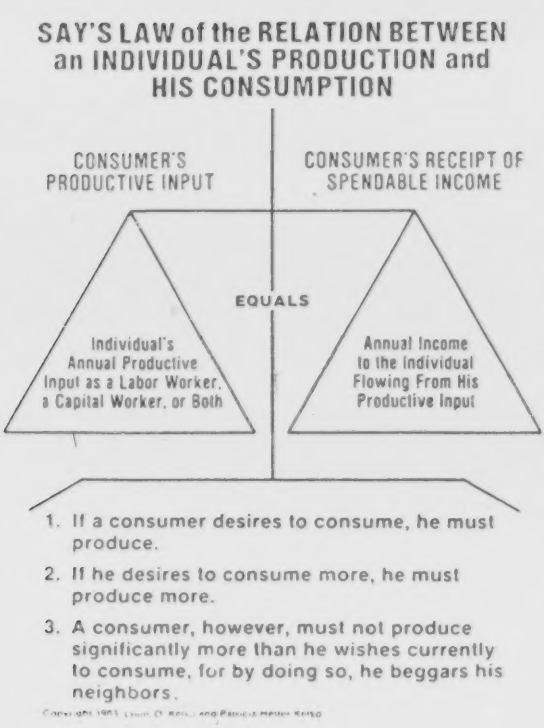

SAY'S LAW of the RELATION BETWEEN
an INDIVIDUAL'S PRODUCTION and
HIS CONSUMPTION
CONSUMER'S
PRODUCTIVE INPUT
CONSUMER'S RECEIPT OF
SPENDABLE INCOME
EQUALS
Individual's
Annual Productive
Input as a Labor Worker,
a Capital Worker, or Both
Annual Income
to the Individual
Flowing From His
Productive Input
1. If a consumer desires to consume, he must produce.
2. If he desires to consume more, he must produce more.
3. A consumer, however, must not produce significantly more than he wishes currently to consume, for by doing so, he beggars his neighbors.

Although this is not the place to particularize the details, clearly what is needed, once the factual error in the national economic policy is corrected, is a carefully developed new federal code of laws relating to capital financing throughout the economy and to bringing about the capital worker employment, and Lifetime Employment — American Style, of all American citizens, both in the private sector and in the public sector.

**CAN CONGRESS BE FAULTED FOR NOT SOONER FACING THE ERROR IN THE NATIONAL ECONOMIC POLICY AND ITS IMPLICATIONS FOR THE ECONOMY AND FOR THE NATION?**

In all candor, we do not think so. If we were given the power to rewrite history along ideal lines, we might say that if Congress in 1932, at the beginning of the New Deal had asked "Why are people poor?", and had found the right answer, instead of of declaring war on the **effects** of poverty, life would have been vastly different, and presumably much better.

But that would have required rewriting much more of history than just political history. It would have required leaping forward over a half-century of industrial history, political history and economic history.

To be realistic, only now, for the first time ever, are all the social, political, financial and industrial technologies available to accommodate the problems attendent upon employing one hundred million or more capital workers constructively in the economy, thus putting the United States on the basis of a private property, free market, capitalist democracy. These are the requisite technologies:

I. The perfection of the corporation has now reached a point where it is the dominant form through which our business is carried on and productive assets are owned. The ownership of the corporation can be subdivided to any degree desired, simply by issuing shares of its stock.

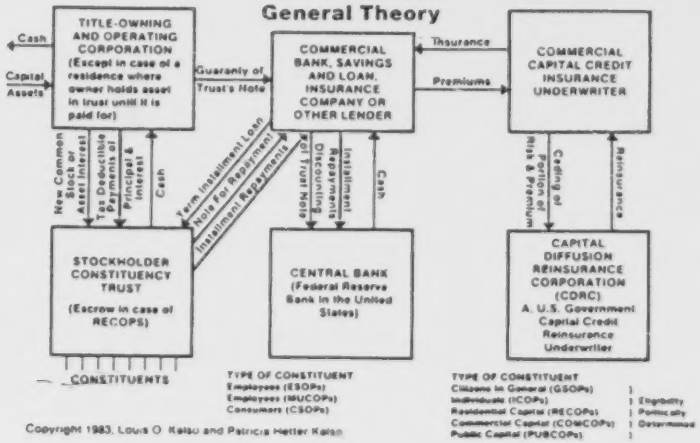
II. The modern computer can reliably identify owner-stockholders, no matter how numerous, and can track and protect their property rights, including their rights to receive full payout of the wages of their capital, the yield of the assets represented by their stock. This is indispensable to the existence and protection of private property in a modern industrial state.

III. Switching from outmoded, pernicious, savings-based financing methods, which assure that only the rich will get richer, and that the presently uncapitalized 95% will stay uncapitalized, to **commercially insured capital credit**, will assure optimum economic growth and efficiency and will synchronize economic growth with the rise in earning power of the now economically-underpowered majority. We will then realize the full effectiveness of capital ownership as a way to engage in production and earn income, until the ends of our lives.

The following diagram illustrates the use of commercially-insured capital credit and the eight capital financing strategies we have so far developed to restructure the American economy into a private property, free market, democratic capitalist system. Since each of the eight strategies employs the logic of the ESOP, the diagram is a generatized schematic.

## HOW DEMOCRATIC COMMERCIALLY INSURED CONTRACT FINANCING OF CAPITAL TRANSACTIONS WOULD WORK

### General Theory


TITLE-OWNING AND OPERATING CORPORATION (Except in case of a residence where owner holds asset in trust until it is paid for)
Cash
Capital Assets
Guaranty of Trust's Note
COMMERCIAL BANK, SAVINGS AND LOAN, INSURANCE COMPANY OR OTHER LENDER
Insurance
Premiums
COMMERCIAL CAPITAL CREDIT INSURANCE UNDERWRITER
New Common Stock or Asset Interest
Tax Deductible Payments of Principal & Interest
Cash
Term Installment Loan Note For Repayment
Installment Repayments
Tax Deductible Repayments of Trust Note
Installment Cash
Premiums & Payments
Claims
Reinsurance
STOCKHOLDER CONSTITUENCY TRUST (Escrow in case of RECOPS)
CENTRAL BANK (Federal Reserve Bank in the United States)
CAPITAL DIFFUSION REINSURANCE CORPORATION (CDRC) A U.S. Government Capital Credit Reinsurance Underwriter
CONSTITUENTS
TYPE OF CONSTITUENT
Employees (ESOPs)
Employees (MUCOPs)
Consumers (CSOPs)
TYPE OF CONSTITUENT
Citizens in General (GSOPs)
Individuals (ICOPs)
Residential Capital (RECOPs)
Commercial Capital (COMCOPs)
Public Capital (PUBCOPs)
Eligibility Politically Determined

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This concept is further discussed in Exhibit I attached hereto.

It should be remembered that capital is ten times more powerful than our present constricted one-factor financing and our dependence on income redistribution permit it to be. A typical equity stockholder today receives about 10% of the net income earned by the assets represented by his stock.

**TWO-FACTOR FINANCING TECHNIQUES MAKE CAPITAL CREDIT AND TOP FINANCIAL ADVICE OF BUSINESS CORPORATIONS AVAILABLE FOR THE BENEFIT OF THE "LITTLE MAN"**

This phenomena comes about because of the almost totally neglected or misunderstood characteristic of all two-factor financing tools: **Simulfinancing.** Attached hereto as Exhibit V is an explanatory memorandum entitled "Simulfinancing: How to Make Capital Financing Dollars Work Harder".

In the course of financing acquisitions of capital assets for itself, the corporation, using two-factor financing, automatically, and with little or no additional cost — even with cost saving — makes capital workers (depending on which method or methods are used) out of individual employees, consumers, or congressionally identified eligible stockholders.

Two-factor financing methods involve no "giving" of anything to anyone, except according citizens the opportunity to buy and pay for corporate stock, not out of the stockbuyer's labor or welfare income, but out of the capital-earned income flowing from his newly acquired capital.

And that "opportunity" is not given by the generosity of the corportions involved — if we correct the error in the NEP. It is given by the American Constitution. The right to be productive is first in the hierarchy of all human rights. In our advanced industrial economy, that necessarily implies acquiring ownership of a viable holding of productive capital before or by the time of retirement as a labor worker. But because of our Stone Age NEP, that human **and Constitutional** right[1] is not merely neglected; it is openly denied, rejected, and repudiated!

**DO EMPLOYERS HAVE A RESPONSIBILITY TO CREATE NEW CAPITAL WORKERS?**

It is a commonplace that the number one characteristic sought in employees in American industry is worker loyalty.

But does not the privilege of receiving employee loyalty imply a duty of employer responsibility?

Has anyone ever heard of the reciprocol of worker loyalty: employer loyalty?

In our economy, management, representing owners, without any guidance from Congress, has the **exclusive** power of determining who will become capital workers.

— So to whom, under the present NEP, do they accord capital ownership in connection with changes in ownership and new capital formation?

(1) See "The Right To Be Productive," Exhibit I hereto.

— Themselves and the present owners, of course. Just as socialist bureaucrats invariably conclude that their own needs, in an economy that allocates income according to need, as they see them, are disproportionately greater than the needs of all others, so corporate management and the present capital-owning elite 5%, absent Congressional guidance through a sound National Economic Policy, seek to further concentrate the ownership of all capital within their own ranks. They do not equate, and without economic policy guidance from Congress, will never equate, their own needs for Lifetime Employment - American Style with the similar needs of all of their employees.

## CONVENTIONAL SAVINGS-BASED FINANCE

A cruder way for business and industry to achieve economic growth than savings-based financing could not be devised. It fails to solve the twin problems of:

(1) The unemployment **and the inevitable underemployment** of the 95% of potential American capital workers whose unemployment and **underemployment** is due to a curable disability: they own insufficient or no capital.

(2) The economy's inability to finance a vast capital expansion to equip this awesome number of people with capital, while simultaneously raising their income-earning power.

Conventional one-factor capital finance is a hopelessly inadequate Rube-Goldberg machine. It limits capital financing to available financial savings. It uses savings from anywhere in the world, which means we are constantly creating more new foreign capital workers in the U.S. economy than new U.S. capital workers. It can be turned on and off at the whim or caprice of the savings manipulators, and finally, to the extent it succeeds, the whole process enhances the earning power of those who relatively, and often absolutely, do not need it and cannot use it — can't even take it with them when they leave. But it does not raise the earning power of the 95% of economically underemployed Americans who do not own viable holdings of non-residential capital.

Thus conventional finance sets up the whole economy for socialist redistribution of income from the minority who earn more than they can use, to the majority who earn less, or earn nothing, and who are forced by this policy vacuum into welfare, both open and concealed.

We have already enumerated the most conspicuous evil effects of this nonsense.

## GENERAL COMMENTS

U.S. economic greatness was built on innovation, quality mass production and competitive products. Today, we're losing on all three fronts to Japan, and to a lesser degree to other nations.

We submit that is time for Congress to stop being "elected bureaucrats," socialistically redistributing other people's income, and to change from the wrong strategic course chosen and maintained since 1932, to the correct strategic course for a private property, free market, capitalist democracy.

We need an industrial age economic policy, not the Stone Age one we live under.

In the twelve years that I have been talking with Senators and Congressmen, Congress has preoccupied itself with urgent matters and turned a deaf ear to the important matter of a sound National Economic Policy and a sound private property, free market, capitalist democracy.

The Capitalist Manifesto was published in 1958 — nearly 28 years ago, and The New Capitalists two years afterwards.

The message of those two books was that there are two ways, not just one, for individuals to engage in production and earn income, and that the unrecognized one, capital work — long ago overtook the recognized one, labor work, in relative importance.

Every Senator and Congressman takes an oath to uphold the Constitution and [illegible] of the land.

— That includes upholding the common law of **private property.**

— But the law of private property — believe it or not — contains two critical limitations that change from passive to active if owning capital, in fact, is a way to engage in production and earn income:

(1) The rights of private property do not confer upon the owner the right to use the thing he owns to injure his fellow man or the property of his fellow man, and

(2) The rights of private property do not confer upon the owner the right to use his property in ways contrary to the public welfare.

The moment Congress recognizes that owning productive captial is a way to engage in production and earn income — in other words when it corrects the NEP to square with the facts of life — the principle of limitation in the common law leaps to life:

**ONE MAY NOT ACQUIRE PRODUCTIVE POWER THAT EXCEEDS HIS ABILITY OR DEMONSTRATED INTENT TO USE IT TO SUPPORT HIS FAMILY LIFESTYLE, WHEN TO DO SO INJURES HIS FELLOW MAN,**

—But fellow citizens are injured, so long as there are economically underpowered people in the economy, and

—So long as legitimate means can be devised to enable the economically underpowered to acquire that productive power and pay the same price for it as would the owners of excessive capital holdings.

The ESOP and the seven other tools for implementing the democratization of American capitalism make easy the task of government in carrying out its affirmative obligations as lawmakers under the common law of property. This is the obligation to assure, so far as reasonably practicable, that capital owners do not hereafter acquire more capital earning power than they actually use for consumption and enjoyment by their families, so long as any family in the economy lacks capital earning power.

The easy way to control excessive capital accumulation is to make capital ownership grow where it is needed; i.e., under the ownership of underemployed citizens who have a Constitutional right to acquire capital ownership so they can be economically autonomous and get off the backs of their fellow citizen-taxpayers and their fellow citizen-consumers.

Congressional control thus includes constructively harnessing the natural acquisitive instinct of all citizens in order to restore order, integrity, craftsmanship and competitiveness to the American economy.

These are the steps that will enable Congress to get itself back into its proper role of policy making and out of the role of "an assemblage of elected bureaucrats" redistributing the property of the citizens to keep the peace.

The Financial Planner

# The Right to be Productive*

by Louis O. Kelso and Patricia Hetter

Louis O. Kelso originated the species of financing techniques of which the Employee Stock Ownership Plan (ESOP) is the best-known. A corporate and financial lawyer who headed his own law firm for many years, Mr. Kelso is now chairman of the board of Kelso & Co., Incorporated, a San Francisco investment banking firm specializing in ESOP financing and other financial designs incorporating the principles of two-factor economics.

Mr. Kelso is also an economist and social thinker whose theoretical insights into the structure and organization of modern industrial economies are considered by a growing number of influential people to offer effective new solutions to economic problems which conventional concepts have proved unable to solve.

Mr. Kelso has set forth his general economic theory in three books, **The Capitalist Manifesto** and **The New Capitalists** (co-authored by philosopher Mortimer J. Adler, Random House, 1958 and 1961, respectively, both republished by Greenwood Press, Westport, Conn.) and **Two-Factor Theory: The Economics of Reality** (co-authored by political scientist Patricia Hetter Kelso, Random House, 1967; Vintage Books paperback edition, 1968), as well as in many articles, essays and monographs.

He holds the degrees of B.S. in finance, cum laude, and LL.B. from the University of Colorado, where he was editor-in-chief of The Rocky Mountain Law Review, and later taught constitutional law and municipal finance as an associate professor. As a practicing lawyer in Denver, he specialized in municipal bonds and public finance.

Mr. Kelso is a director of a number of corporations, including AEtna Variable Annuity Life Insurance Company (Hartford), and several of its affiliates.

He is a member of the San Francisco Committee on Foreign Relations. Mr. Kelso's books and articles have been translated into several languages.

Patricia Hetter has been associated with Louis O. Kelso since 1963, first as his writing collaborator during his long career as a corporate and financial lawyer and then as vice president of Kelso & Co., Inc., San Francisco, since 1975.

With Louis Kelso, she co-authored **Two-Factor Theory: The Economics of Reality**, which in 1967 introduced the concept of ESOP financing. Over the years, she has co-authored with Mr. Kelso innumerable articles, monographs, occasional papers, Congressional submissions, and other writings on capital (two-factor) theory and its implementing techniques and social implications. Among them was, "Uprooting World Poverty: A Job for Business," which won the First Place 1965 McKinsey Foundation for Management Science Award. Most recently, she is the co-author of Kelso's fourth major book, **Social Capitalism: Who Should Produce the Wealth of Nations?**, to be published later this year, and of "Sychophantasy in Economics," a critique of George Gilder's **Wealth and Poverty**, to appear in **The Great Ideas Today, 1982**, published by Encyclopedia Britannica, Inc.

Patricia Hetter holds a B.A. degree in government and philosophy from the University of Texas at Austin. For seven years, she studied the Swedish welfare state by living and working in it as an international marketing and advertising specialist for one of Scandinavia's leading advertising agencies. She is also vice president of the Institute for Economic Systems and editor of the Institute's very occasional newsletter, The New Capitalist.

*Copyright 1982, Louis O. Kelso and Patricia Hetter. This monograph is based in part upon ideas developed in earlier writings, beginning with the publication in 1958 of **The Capitalist Manifesto** (Kelso and Adler, Random House, New York, and Greenwood Press, Westport, Connecticut) and continuing with publication of **The New Capitalists** (Kelso and Adler, Random House, New York, 1961, and Greenwood Press, Westport, Connecticut), **Two-Factor Theory: The Economics of Reality** (Kelso and Hetter, Random House, 1967), and **Social Capitalism: Who Should Produce the Wealth of Nations?** by Kelso and Hetter, soon to be published. All rights, including the right to reproduce the writing or portions thereof in any form, are reserved under International and Pan American Copyright Conventions.

MARK O. HATFIELD
OREGON

United States Senate
WASHINGTON, D.C.

December 17, 1982

Dear Colleague:

At a time when millions of Americans are out of work, and all too familiar remedies for our economic maladies re-appear again, it is important that we reflect on the basic direction of our democratic society. In Dr. Louis Kelso's words:

> "awareness is growing that the goal of the American revolution, the drive toward democracy, was side-tracked in 1932 and has been side-tracked ever since through the machinations of the economists and the greedy .... Each citizen has the power to vote at carefully planned political elections but the bulk of the economic power of the society is held by a tiny minority - 5% of the population."

Dr. Kelso, father of the Employee Stock Ownership Plan, does not suggest more government redistribution schemes that would create dependency and insecurity - but rather, he suggests that we give laborers a piece of the action through capital ownership.

On Thursday, March 4th of this year, Dr. Kelso testified before the Senate Committee on Appropriations. The enclosed article, The Right to be Productive sets forth the substance of that testimony. Its implications for us in the coming session of Congress are momentous. I encourage you to read it.

Sincerely,

Mark O. Hatfield
United States Senator

MOH/rsc

**ON DECEMBER 17, 1982, UNITED STATES SENATOR MARK O. HATFIELD, CHAIRMAN OF THE SENATE APPROPRIATIONS COMMITTEE, MAILED THIS LETTER WITH A COPY OF THE RIGHT TO BE PRODUCTIVE TO EVERY U.S. SENATOR AND CONGRESSMAN.**

**L.O.K.**

from

The Financial Planner

Vol. 11/No. 8/August 1982*

Vol. 11 No. 9/September 1982 **

A half century of bad advice and misguidance of the people of the United States by the practitioners of "economics," the illegitimate offspring of the social science of political economy, draws to a close. Awareness by the people that they have somehow been misled about the economy—about the political-economics of a free society—is abundantly reflected in their daily conversations, on television and radio, in the press, and in the daily internal deliberations of almost every institution.

Beginning with the onset of the Great Depression, it soon became clear that the social science of political economy could not reconcile the idea of private property in the means of production with the idea of government responsibility for a just and workable distribution of income. As this realization grew, political economics, with its concerns for the law of property and economic justice, was deserted by all who sought involvement, employment, prestige or power in the new discipline, economics freed of these troubling limitations. Thus was born what its practitioners call "modern empirical economic science."[1]

At the moment when political democracy in America should have grown into true democracy by our discovery and implementation of democracy's economic dimension, the seeds of the destruction of democracy sprouted forth in the form of the modern anti-property doctrine of Keynesian socialism. It was labeled "The New Deal." Our dangerously imperfect democracy, erected upon an attempt to combine political democracy with economic plutocracy, took a sad wrong turn.

Under the battle cry of "human rights over property rights" (as though anyone other than humans could have "rights" of any kind), the bastard science of economics grew to become so powerful, and its practitioners so strategically placed throughout the society, as to gradually take over, without portfolio, the de facto government of the nation in all matters economic. In the vast and urgent domain of the production and distribution of subsistence and affluence, the elected officers of government, in effect, deferred to the self-styled experts—the economists. By marshalling social action behind provocative questions as to how the American society could alleviate the *effects* of poverty, and claiming the exclusive expertise and knowledge to propose answers to those questions, the economists made themselves all-indispensable and all-powerful. Mostly trained in the disciplines of "economics" and administrative law, they became the fastest growing profession in history, numbering well in excess of 100,000 in the United States alone; they raised their income from virtually nothing in 1932 to more than $5 billion in 1982. They sycophantically welded themselves into a priesthood primarily motivated by their conspiracy to power.

For the past half-century, the economists have pre-empted much of the brain power and energy of the entire society with answering variations of the deceptive wrong question: "How can we ameliorate the effects of poverty?" The ingeniously misguided leadership of the nation gushed forth a vast stream of clever solutions to this totally erroneous and anti-democratic question. Operating through an unarticulated alliance between the plutocracy that, with help from the economists, perennially owns the productive capital of the economy and their own income-redistributing innovations, both the economics professionals and the rich have prospered mightily. For the plutocrats, the ownership of capital tidily remains in the top wealth-holding five percent of the population; for the economists, high incomes, power, prestige, and academic and media adulation pour forth in ever more gratifying cascades.

But today, awareness is growing that the goal of the American revolution, the drive toward democracy, was side-tracked in 1932 and has been kept side-tracked ever since through the machinations of the economists and the greedy. Their rallying cry of "let us tell you how you can ameliorate the effects of poverty" involved a senseless red-herring question. The right question, which would have speeded the nation forward in its quest for true democracy—*political democracy within economic democracy*—was and is: "Why are people poor?"

For the economically disfranchised majority who, systematically and imperceptibly, have been deprived of the opportunity to enhance their productiveness through their legitimate acquisition of productive capital as the value of their labor power was diminished by the relentless advance of technology, those fifty years provided a radically different experience. As it became progressively easier for capital workers, through their property, machines, and sophisticated technology, to produce goods and services, it became progressively harder for labor workers to earn a living. Wives have been driven from their homes by poverty in order to help their husbands

continued

* Pages 51 - 61
** Pages 87 - 110

**Productive** *continued*

earn a living. The tenuous quality and amenities of life previously achieved are disappearing. Desperation and alienation over the struggle to survive have come to increasingly dominate the character of the people. The invisible violence of business finance that makes the overproductive five percent who own all the nation's capital ever richer and more productive, with clinical precision keeps the underproductive majority in a deepening shadow of economic servility and dependence.

This monograph deals with the missing right question and with its correct answer. It explains to Americans, and to the world, how we can quickly correct the strategic and tactical mistakes we have made in our search for economic democracy, and how we can build a property-oriented society of economically and politically powerful individuals—a Social Capitalist economy.

Incidentally, it throws important light on how we can reunite the fragments of the crippled pseudo-social sciences of economics and politics into a valid science of Social Capitalism.

**"When a society is perishing, the true advice to give to those who would restore it is to recall it to the principles from which it sprang."**[1]

"We hold these truths to be self-evident: that all men are created equal; that they are endowed by their Creator with certain inalienable rights; that among these are life, liberty, and the pursuit of happiness. That, to secure these rights, governments are instituted among men, deriving their just powers from the consent of the governed. That, whenever any form of government becomes destructive of these ends, it is the right of the people to alter or to abolish it and to institute new government, laying its foundation on such principles and organizing its powers in such form as to them shall seem most likely to effect their safety and happiness. . . ." (Extract from the Declaration of Independence, July 4, 1776.)

"We the people of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defense, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America." (Opening paragraph of the Constitution of the United States of America.)

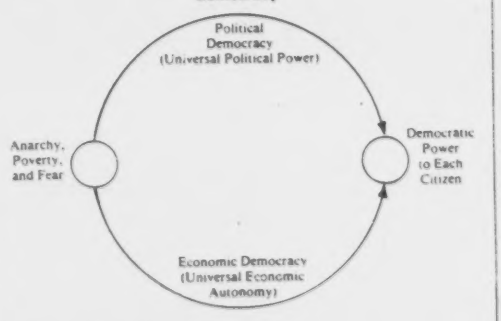
"This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land. . . ." (Article VI of the Constitution of the United States of America.)

"No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." (Amendment V.)

". . . No State shall make or enforce any law which shall abridge the privileges of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." (Amendment XIV.)

**Diagram A**

**Democracy**


Political Democracy (Universal Political Power)
Democratic Power to Each Citizen
Economic Democracy (Universal Economic Autonomy)
Anarchy, Poverty, and Fear

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## Our flawed democracy

It is our thesis that the Declaration of Independence and the Constitution of the United States, interpreted in the light of American history and world history, promise us—the American people—democracy; that only through our democratic example to the world, not through our military might, nor by our meddling in the affairs of other nations, nor by our selling them at each other's throats through "strategic arms sales," can the cause of democratic freedom spread from the United States to other parts of the world.

We find no instance in the annals of history of the destruction of wrong ideas—like the ideas of socialism or communism—by bullets, bombs, napalm, chemicals, missiles, battleships, submarines, armies, or navies. Bad ideas are destroyed only by good ideas; wrong ideas are corrected only by the discovery and practice of right ideas."[2]

*The United States today is not a constitutional democracy.* It is a tantalizing but cruel mixture of political democracy and economic plutocracy. Each citizen has the power to vote at carefully planned political elections, but the bulk of the economic power of the society is held by a tiny minority—five percent of the population. Today, substantially all of our nation's mighty capital instruments are owned by this minority, and, as things stand, they will own the new capital instruments of tomorrow.

A political democracy that is not an economic democracy is but half democratic. It contains the seeds of its own destruction, as Marx and Engels maintained. At the same time, it contains the seeds of its own democratic perfection. The American people, through their duly elected representatives in Congress, and they alone, can determine which of these seeds shall flower.

## Enlightenment begins with calling things by their right names

Since this monograph deals with an

*continued*

idea which may be new to many readers—the idea of Social Capitalism—our communications will be helped by defining some terms.

**Economic Democracy:** Economic democracy exists when every citizen personally owns and possesses the *power to produce* the income he needs to support and enjoy the lifestyle he reasonably chooses for himself and his dependents. For more than two centuries, we have been moving away from this ideal. Day-by-day, the many are increasingly dependent upon welfare, boondoggle (welfare disguised as jobs), redistribution, and charity. With negligible exceptions, only the rich owners of productive capital—the capital workers who make up about five percent of the population—are economically autonomous. Of the remaining 95 percent, some earn a good living by their labor, although often their labor income is bulwarked with welfare disguised as labor pursuant to our national full labor employment economic policy. Others are reduced to living openly on welfare and charity. In an economy in which the input of capital workers is so large in relation to that of labor workers,[4] if we are to avoid the social frictions and inflationary impact of redistribution of income, and if we are each to have a full measure of human freedom, none can enjoy an economically good life without significant income flowing to him from his ownership of capital.

**Social Capitalism**—A national political economy characterized by an economic democracy within a political democracy.[5]

**One-Factor Economics**—Any economic theory that fails to regard capital and capital workers as factors of production in the same functional senses that labor workers are a factor of production is a one-factor theory. This includes Keynesian demand-lopside economics, the current fad of supply-lopside economics, and all macro-economic concepts, past and present, other than Social Capitalism. In its failure to move toward making redistribution-dependent consumers self-supporting, the new "supply-side" economics merely assures that Congress and the states, not the President, will be held responsible for spreading the welfare state to its logical conclusion: socialism.

**Labor Worker**—An individual who engages in economic production through the physical and mental powers of his body.

**Capital Worker**—One who engages in economic production through his privately owned capital. The capital worker produces vicariously; he is not generally required to be personally present at the scene of production. He *earns* his living through his capital.

**Say's Law**—See "Morbid Capital" below and Diagrams C and D.

**Morbid Capital**—This is a graphic, but accurate, name for a hitherto unrecognized phenomenon that is explicit in British common law and was long ago explicitly adopted into the fabric of the American common law. It relates to the two historic limitations recognized by the law as inherent in the sum of property rights a man may possess in a thing he owns. These limitations are: (1) the ownership of private property does not include the right of the owner to use the property in a way which injures the property or person of another; and (2) the ownership of private property does not include the right to use that property in ways which injure the public interest or the public welfare. Since the theory of Social Capitalism (capital theory) recognizes both labor workers and capital workers as economic producers in the identical functional, economic, political, and moral senses, a simple but long-neglected truth comes into focus: *the purpose for which an individual in a free society may legitimately engage in production is consumption by himself and his dependents of the income he produces.*

Within these limitations on private property, a man may improve, increase, and refine his capital productive power so long as income from that productive power is used to support his self-chosen standard of living for himself and his dependents.

However, the double-entry bookkeeping logic of a market economy, normally referred to as "Say's Law,"[6] for any given time period equates the market value of goods and services produced by each participant in production with the income distributed out of the process of production to that individual. It follows, therefore, that income *in excess* of that used for consumption, whatever the reason for the excess, can and will be used only to acquire additional capital productive power, which in turn will produce further excess income, which in turn will be used to acquire further excess capital productive power, etc., *ad infinitum*. Such excess productive power we call "morbid capital," because its nature, like that of cancer, is to grow without symbiotic relationship to the organism to which it is attached. Morbid capital violates the common law limitations inherent in private property because, without benefiting its owner, it beggars others by depriving them of economic autonomy. Morbid capital is contrary to the public interest because it results in strife and suffering and is economically undemocratic. Non-capital-owners are deprived of the very great direct benefits of individual capital ownership. Excessive ownership of capital by the few makes the majority weak, parasitic, and insecure. The morbid capital of the rich destroys the possibility of economic democracy for the poor.[7]

**Feasibility Principle**—This term relates to the financing of capital. It is the reasonable expectation, arrived at after careful analysis and experienced evaluation, that a capital asset will pay for itself, i.e., throw off sufficient net income to pay its costs of acquisition within a planned period of time (the rule of thumb in business is three to five years), and thereafter, its productive power preserved by proper maintenance, depreciation policies, and research and development funding, continue to produce income for its owners indefinitely. "Feasibility" is the basic logic of capital acquisition in the business world. Whether articulated or not, it has always been so.

**Collateralization Principle**—This is a precaution universally employed in the United States since 1776 in financing the acquisition of capital assets; it reinforces feasibility logic. "Collateralization" is what occurs when an individual buys newly issued stock for cash or puts assets at risk through mortgage or other type of encumbrance to doubly guaranty repayment of acquisition credit. *Collateralization serves an insurance function, insuring against the risk that the acquired asset may not pay for itself as contemplated by the feasibility plan.*[8]

Not only is collateralization a crude, inefficient and enormously expensive way of insuring the feasibility risk in capital financing, but there are decisive social and political reasons why it should not be used. It limits access to credit to buy capital to those who already own substantial amounts of capital and who can self-insure the feasibility risk. It is the chief cause of capital morbidity. We call the collateralization requirement the "Divine Right of Kings—American Style," because it serves the same function in the American economy and in other modern economies as the Divine Right of Kings did for hundreds of years in Europe: *it keeps all of the ownership of capital within the top five percent of the population!* The *economic function* of collateralization, from every logical aspect, should be treated as a casualty insurance problem, because *it is* a casualty insurance problem. We call such insurance "capital diffusion insurance."

Not only is casualty insurance in general the oldest of the financial arts, but the cost of such insurance is minimized by competition and is constantly adjusted to market experience.

## Understanding economic autonomy

The "feasibility" assured through capital diffusion insurance is the feasibility of the enterprise in which the credit-

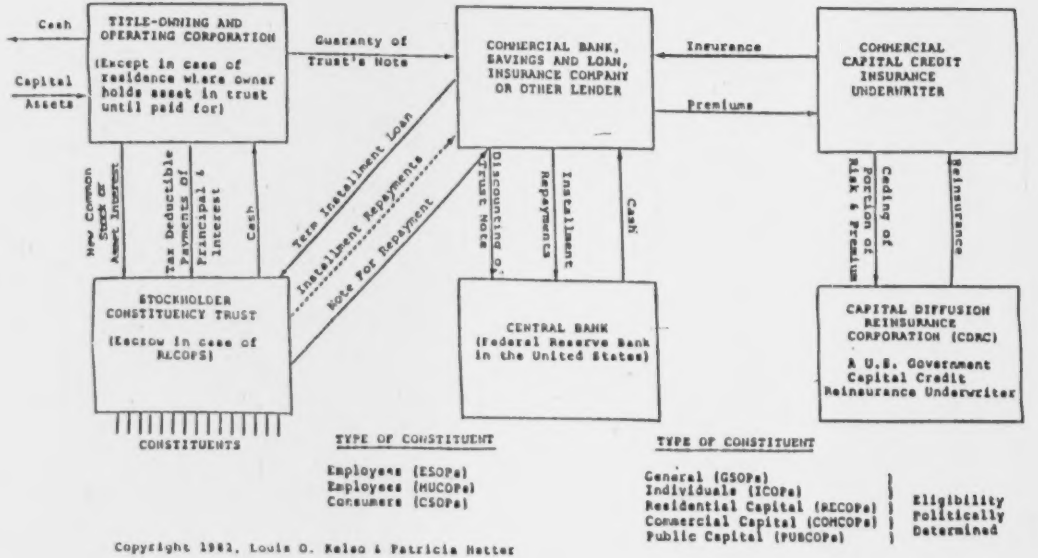
*continued*

Diagram B —

COMMERCIALLY INSURED

CONTRACT FINANCING OF CAPITAL TRANSACTIONS

General Theory*

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financed investment is being made. The insurance is thus *not personal to the investor*. The performance by him of his duties—initially to apply the yield of the assets he acquires to repayment of the acquisition debt and interest—is automatically taken care of by the logic of financing designs built upon capital theory. This is the logic of the Employee Stock Ownership Plan (ESOP) and of each of the other seven financing methods for implementing a Social Capitalist economic policy.[9]

By relying on the feasibility principle, backed up by capital diffusion insurance and financed through pure credit, we can enormously reduce the cost of financing any capital acquisition, public or private, while opening up the opportunity to buy productive capital to any individual, through use of one or more of the eight financing techniques designed to implement capital theory. Since the earliest and most extensive uses of capital implementation technology will undoubtedly be in well established businesses, municipalities and utilities, the cost of capital diffusion insurance in those instances should be small. Economic feasibility in every case will improve as consumer incomes and purchasing power from capital sources rise.[10]

Up to now, our failure to rationalize the phenomena of capital acquisition finance and the necessity for broad individual ownership of capital into a feasibility problem plus a casualty risk insurance problem has resulted in massive hidden costs not primarily borne by entrepreneurs, businesses, financiers, or financial institutions, *but by the society as a whole*. To reckon such costs, one would have to add all costs that would be *eliminated* if we had an economically democratic nation, i.e., a nation of economically autonomous consumers. These unnecessary costs would include:

—All transfer payments in the economy. In 1980, at the Federal level alone, these amounted to half of the U.S. budget. The burden at the state level is comparable, even without the "New Federalism."

—A major part of all private business debt, public debt, and individual debt incurred for private capital investment (e.g., housing debt), since debt incurred through capital theory financing is short term debt and is progressively liquidated and fully converted into equity in about five years. The warehousing of morbid capital, so cherished by its owners and their financial helpers, would gradually cease.

—The costs of public and private pension plans and profit sharing plans would be eliminated in favor of portfolios of high-yielding corporate equities issued in capital acquisition transactions.

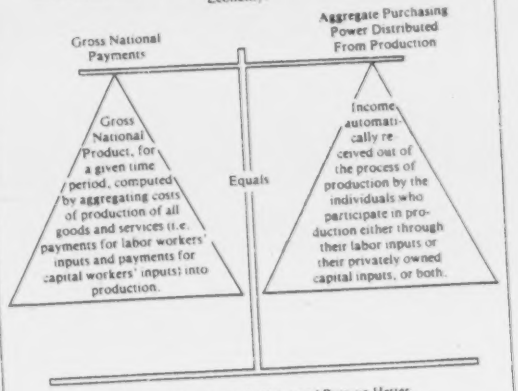
—The incalculable costs reflected for the most part in misery, deprivation, and eternally lost opportunities for a good economic life for a large part of the entire U.S. population would gradually be eliminated.

**Diagram C**

**Say's Law**

In A Market Economy the Market Value of Good's And Services Produced During A Given Time Period Is Equal to the Income Distributed to the Participants In Production.

Say's Law Is Simply A Prose Statement of the Principle of Double-entry Bookkeeping And of Barter, the Logic of A Private Property, Market Economy.


Gross National Payments
Aggregate Purchasing Power Distributed From Production
Gross National Product, for a given time period, computed by aggregating costs of production of all goods and services (i.e. payments for labor workers' inputs and payments for capital workers' inputs) into production.
Equals
Income, automatically received out of the process of production by the individuals who participate in production either through their labor inputs or their privately owned capital inputs, or both.

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The amount of morbid capital parasitically living in the economy at any time is thus a partial measure of the burden our society—particularly its voiceless majority—bears under the Divine Right of Kings—American Style, the one-factor economists, and the tiny minority of capital-worker plutocrats.

Not only is our presently hidden economic feasibility insurance premium infinitely greater than it should be, but it is imposed on an economy that, in terms of productive capital at work for peacetime purposes, is but a fraction of what it would be if we had become a Social Capitalist economy as recently as ten years ago. Not only could the enormous tangible and intangible economic costs of morbidizing capital rather than putting it to work for economically underpowered people be avoided, but we would eliminate the moral and political costs of denying to our capital-less majority life, liberty, and equal protection of the laws in the sense contemplated by the Declaration of Independence and the Constitution.

Neither the capriciousness of the owners of morbid capital, nor the quantitative limitations on the amount of morbid capital available to finance growth, would any longer limit our economic growth.

Access to pure credit[11] and capital diffusion feasibility insurance would free corporations of the need to finance growth internally in after-tax dollars. Not only would this "take the brakes off" corporate growth, but private property could be restored to stockholders who would then collect the wages of their capital as regularly as labor workers collect the wages of their labor. Broadening the ownership of capital through Social Capitalism makes sense only if capital workers systematically collect the full wages of their capital. These are about twelve times the average yield of equity stock to stockholders today.[12]

The size of corporations, which more than anything else in the U.S. economy today reflects the aggregations of individual holdings of morbid capital, would shrink to the limits dictated by functional efficiency and competition.

The economic support of the unproductive 95 percent of the population, made up of consumers who do not today

continued

**Productive** *continued*

own capital and who, even if they did, would not collect more than a tiny fraction (1/12th) of the wages of their capital, can effectively be shifted to the vast body of mostly not-yet-born nonhuman slaves —newly-formed productive capital—that through high-yield equity stock holdings will come to be individually owned by otherwise economic underperformers.

## Why the American economy does not work

The unemployment of labor workers in the U.S. economy, if we count as employed those who hold boondoggle jobs synthesized pursuant to our misguided economic policy of "full (labor worker) employment,"[14] presently averages about ten percent. However, the unemployment of potentially ready, willing and able capital workers is at least 95 percent of the potential capital work force.[15] Thus, in terms of total work force (labor workers and capital workers), we are perhaps 60 percent unemployed. If we adjust that estimate to treat the holders of "created" or boondoggle jobs as unemployed, which in reality they are, *unemployment of our potential work force is at least 80 percent!*

## Social capitalism

In a market economy, each participant on the economic stage (each citizen) is a consumer who fills one of the following roles:

- He produces an adequate income through his labor, or his capital, or through both; or
- He does not produce an adequate income; or
- He produces through his labor, or through his capital, or through both factors an adequate income *plus* sufficient additional income progressively to enlarge his capital productive power to a multiple—often a large multiple—of the income required to satisfy his consumer needs and wants. This excess is "morbid capital."

The phrase "adequate income" here refers to an income adequate to support the self-chosen consumer lifestyle of the individual producer.

The principal rules binding these participants, if the economy is a Social Capitalist one, are the following:

1. The ideal economy (and the ideal status of individuals within it) is one in which each consumer himself produces, either as a labor worker, or as a capital worker, or as both, the level of income required to support his self-chosen lifestyle. Where a consumer unit consists of more than one individual, the rule applies to the consumer unit. This is economic autonomy and economic democracy.

2. Except for the insufficiently educated, the untrained, or the inexperienced, the labor-productiveness of a consumer cannot, by means acceptable to working people, be increased.

3. But the productiveness of a capital worker can easily be increased through his credit-financed acquisition of capital and through technology, which progressively raises the productiveness of capital workers, but not that of labor workers. One purpose of technological innovation is to reduce production costs —primarily labor costs.

4. Real jobs cannot be "created." They arise only in response to consumer demand. When the consumer demand for them is eliminated through automation or whatever, they vanish. Honest market demand for labor employment arises only when consumers, freely spending their own funds, purchase things produced by labor workers.

5. With governmental assistance, however, apparent jobs or boondoggle jobs can be created. Boondoggle is welfare disguised as jobs to save the faces of the beneficiaries and to confuse taxpayers and consumers who, as unwilling hosts, must pay for it. Like all welfare, whether disguised or not, it is inflationary.

A Social Capitalist economy can be and should be operated to rely upon freely competitive markets to accomplish all valuation and income distribution functions, while assuring the productive vigor of every consumer. A Social Capitalist economy would be free of welfare, boondoggle, and inflation.

It is clear, however, that government, too, must abide by Social Capitalist rules. Two-factor economics provides the system logic, and the eight financing tools discussed below, together with pure credit, provide the implementation logic for transforming our primitive capitalist economy that works for the few into a Social Capitalist democracy that will work for all. In conformity with Blake's Law,[15] our forthcoming book, **Social Capitalism**, blueprints the simple finance and credit mechanisms for bringing these conditions about. Each of the eight financing tools embodies the identical well-tested logic of the ESOP, hundreds of which are operating satisfactorily in the relatively hostile environment of our present economy.

## The constitutional mandate for economic autonomy

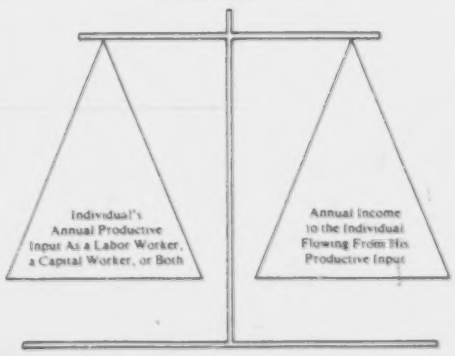
Government, and many governmentally sanctioned and tax supported institu-

*continued*

**Diagram D**
**The Logic of Economic Democracy**

Say's Law as Applied to Individuals

Distribution of individual annual income in a market economy is based upon the individual's annual productive input into the economy as a labor worker, a capital worker, or both.


Individual's Annual Productive Input As a Labor Worker, a Capital Worker, or Both
Annual Income to the Individual Flowing From His Productive Input

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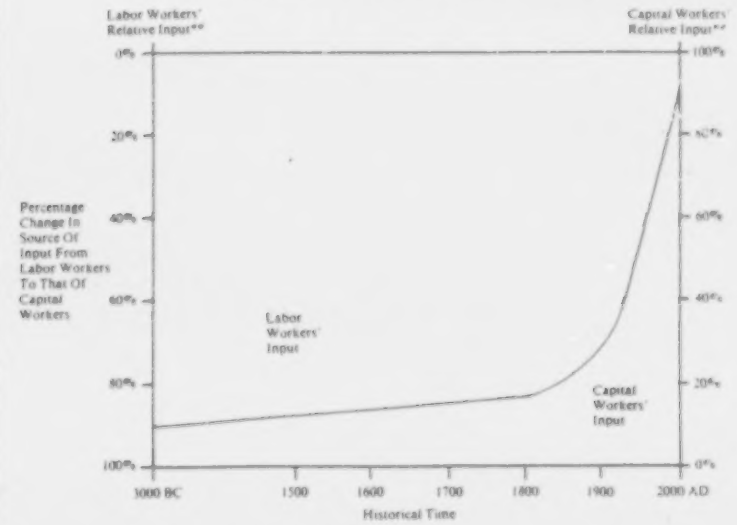
**Productive** *continued*

tions, such as technical schools and universities, agricultural colleges, research laboratories, and the like, promote technological advances which eliminate millions of labor worker jobs every year.[15] Have the labor workers thus displaced been given "due process" when deprived of the power to support themselves through their own labor by receiving equal protection of the laws relating to access to credit to buy capital so they can become self-supporting capital workers?

It appears to us that they have not. Where affirmative government effort and governmentally-encouraged private effort reduces or eliminates the value of the labor workers' property in their labor power, unless due steps have been taken to enable them to become capital workers, they have not received constitutional due process.[15] This would seem equally true of employed labor workers who cannot, if their wages are competitively evaluated, produce sufficient income to enjoy their share of what labor workers and capital workers together produce. As a result of technological change, and by adding the collateralization requirement to the financing feasibility requirement, the labor worker has been unmercifully converted from an economically autonomous person (in a pre-industrial period) into an economic dependent of society.[16] If he uses his political power to rig and elevate his pay, he helps to fire up inflation, of which he and the unemployed are the chief victims. And there is the additional problem of the unemployables, who cannot engage in production as labor workers because of physical or other handicaps, or as capital workers because of their illegal capital handicap.

The same conclusion must be drawn with respect to the application to the non-capital owning majority of the doctrine of equal protection of the laws. This idea is, of course, inherent in the idea of democracy as reflected in the Declaration of Independence and in our Constitution. Access to efficient and effective credit for the purpose of enabling a labor worker, or for that matter someone who is unemployable, to become a capital worker, is inherent in the rights to "life and liberty."[17] When the institutions of finance, organized under federal or state law and regulated as quasi-monopolies by those laws, select at enormous cost, whether from ignorance, oversight, or social indifference, the principle of collateralization usable only by the rich, rather than the principle of commercial risk insurance usable by any citizen, it is a patent denial, contrary to the Constitu-

**Diagram E**
**Through Technology, Capital Workers Displace Labor Workers**




*From **Social Capitalism: Who Should Produce the Wealth of Nations?**
**Estimated on the assumption that the value of each type of productive input is determined in reasonably competitive markets.

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tion, of equal protection of the critical laws relating to access to credit to enable oneself to become productive or more productive.

## The priesthood of the one-factor economists in the United States

During the period 1929 to 1932, a breakdown in the American economy that had been building up for years took place.

We had experienced more than 150 years of progressive transfer of productive power from labor workers to capital workers through technological change,[20] and through the concentration of the ownership of the growing hoard of the nation's capital in the top five percent of the population as the result of conventional finance. The combination of these two forces violated Say's Law[21] to the point where we could no longer cover up or divert attention from the fact that millions upon millions of people lacked the productive power, either as labor workers or as capital workers, to support themselves, while a tiny minority, the rich, could not protect the values of their morbid capital holdings in the face of the resulting collapse of consumer spending.

The economic literature of the time belabored the problem, but never identified the solution:

> "The economic system, for some reason, never succeeds in operating at full capacity. It has been observed that even in periods of prosperity we have some unutilized plants and equipment and a considerable volume of unemployment. This situation not unnaturally suggests that there must be some basic maladjustment which seriously impedes the operation of the economic machine by means of which the material wants of society are supplied."[22]

> "We should not be thinking about how to create new forms of wealth so as to absorb the unemployed, but rather about why our production of old and existing forms of wealth creates unemployment though our production of these old existing and I believe more fundamental forms of wealth have never been adequate for the needs of the American people."[23]

> "America's capacity to produce a richly varied pattern of goods and services has been amply demonstrated. We have not yet shown a corresponding ability to maintain peacetime market demand at satisfactory levels."[24]

Senator Fulbright made the same point: "Much has been said here about our productive capacity. We have already proved that in the war. We can produce. I don't think there is any question about that. The real problem is on the consumption end."[25]

It was in response to this deficit in consumer power that a group of "experts," fired by Keynesian demand-lopside theory, moved onto the scene to restore consumer incomes. In all that they urged, they preserved and intensified the mechanisms of wealth concentration—the source of morbid capital. They carefully avoided offending the interest groups which President Roosevelt called "economic royalists." They steadily maintained, as had earlier generations of political-economists, including Adam Smith and Marx, that capital is not a factor of production and that capital workers do not produce goods and services in the same sense that labor workers do, but that capital is a mysterious catalytic agent, ordained by God to be owned by the rich, which somehow makes labor workers more productive, even though they own none of it. These thousands of one-factor economists and lawyers, heavily charged with Keynesian economics, eventually grew into the powerful priesthood that, in recent decades, has been the self-proclaimed fountainhead of economic "conventional wisdom" in the United States.

Among the incredibly powerful weapons of the cult of one-factor economists is their imperialistic and artful use of pre-emptive wrong questions. Under their prodding in 1932, the New Deal aroused the nation from its confusion and torpor with the challenge, "how can we abolish the effects of poverty?" This powerful wrong question has mesmerized the nation for fifty years. It has consumed time, energy, institutional integrity, and even the blood and lives of the country's youths, in the vain attempt to make the economy work on Keynesian demand-lopside principles.

By proclaiming the exclusive right to credibility in matters economic, the conventional economists established power in the U.S. over man's most basic drives: his urge to survive and, beyond that, his urge to live well. The master pre-emptive wrong question of "how can we alleviate the effects of poverty?" was expanded into subsidiary wrong questions: How can we prop up the incomes of the poor? How can we provide housing for those who cannot afford it? How can we pay for the medical care of those who have insufficient incomes to hire their own doctors? etc., etc.

In spite of the growing power and personnel of the economics cult, doubts did, from time to time, arise. In 1937, at President Roosevelt's request, Congress formed the Temporary National Economic Committee (TNEC), charging it with finding an answer to the question, "What caused the Great Depression?" That investigation still stands as the most massive and thorough analysis ever made of the American or any other economy. With its activities guided by the one-factor economists, the chairman of the Committee, in his closing report in 1941, announced the Committee's conclusion: "We don't know what caused the Great Depression. We only know what ended it—war production." In its September 3, 1979, issue celebrating its own 50th anniversary, but devoting most of its pages to a fifty-year retrospective analysis of the Great Depression, Business Week confirmed that we still do not know what caused the Great Depression; we only know what ended it—war.

The apprehensions reflected in the final report of the TNEC in 1941 were again behind the activities of the Congress in 1945 when it debated the formalization of what had actually been the national economic policy from the first years of the New Deal. The Full (Labor) Employment Act of 1945. The now all-powerful one-factor economists allayed the doubts of Congress about solving the income distribution problems of our advanced industrial economy through labor employment alone by removing the word "full" from the 1945 proposed legislation and adopting a law later interpreted by the Joint Economic Committee as having the same meaning. The Employment Act of 1946. So totally did demand-lopside mania dominate the economics scene that even President Nixon eventually declared himself a Keynesian.

By 1980, the revolt against the failures of demand-lopside economics was in full flower. High income taxpayers, including the higher-paid labor workers, were outraged at the severity of income taxation and the incurring of inflationary governmental deficits to support those with no incomes and low incomes. The unemployed, the unemployable, and the holders of tens of millions of boondoggle jobs within the economy vented their frustration. They were disgusted at finding that, as technological advance makes it easier to produce goods and services, it becomes harder and harder, and even impossible, to make a living, that even with all of our great technology, mothers as well as fathers must join the labor work force, to the neglect of their children and the detriment of family life.

*President Ronald Reagan owes his election to the revolt against demand-lopside economics.* The economic program designed for him by the one-factor economics cultists who have been retreaded with supply-lopside rhetoric, *continued the strategy of attacking effects, not the cause, of poverty.* So

deliberate or organized effort to make the underproductive and non-productive more productive was discussed or proposed. New anti-redistribution rhetoric poured forth. Military boondoggle employment was given new life, with the promise of vast manufacture of new obsolete weapons and the refurbishing of old obsolete weapons. Draft registration was revived. The vast New Deal economic works, the welfare canals that channel redistributed income to the underproductive and non-productive, were closed or constricted, and a burst of private-enterprise-sounding public relations poured forth, proposing "federalizing" these responsibilities to the states.

## The economists' use of myths

The illusion of the validity of one-factor economics is preserved not only by the economists' art of the imperious preemptive wrong question, but by adroit propagation of big myths, or "Big Lies" as Adolf Hitler called them. Economists are in a position to do this because of the vast uncritical deference our society pays them as "experts," and their formidable number (at least 100,000, mostly economists and lawyers), and their sycophantic proximity to the seats of power in and out of government. One of their most destructive deceptions is perpetuated in a single word, a word constantly on the lips and in the writings of all who are concerned with business, finance, labor, economics, or politics.

The word is **productivity**. It purports to measure the productive performance of a labor worker or group of labor workers *as labor workers* for the purpose of comparing such performance with the "productivity" of the same persons during another period or with "productivity" of other labor workers.

In reality, there are, of course, two kinds of participants in production—labor workers and capital workers. But the capital workers, for purposes of this deception, are treated as if they do not exist, because the one-factor economics clergy never functionally treats capital workers as engaged in production in the same sense that labor workers are. When confronted with this charge, by the way, they protest they are as desirous to see capital ownership broadened as anyone. In fact, however, they have never in their writings or public utterances urged broader capital ownership, nor have they put forward an organized effort to enable more people—tens of millions more—to become capital workers. They have never sought to restore property integrity to capital so that capital workers would receive the full wages of their capital, thus making smaller holdings of capital significant. None of them has ever raised a finger in support of the right to be or become productive through capital ownership as the productive value of labor now thrives. They call income produced by capital work "unearned income"—the equivalent of the Marxists' feeble claim that the yield of capital is simply labor workers' wages stolen from the helpless workers. Our national economic policy, that shining monument to one-factor economics, is the (Labor Workers') Employment Act of 1946. The chief instrument for constant reaffirmation of this one-factor mythology is the word "productivity."

Now "productivity" is the ratio of total output (usually in dollars) of the entity under discussion, resulting from the aggregate inputs of capital workers and labor workers, divided *only by labor workers' input* measured in hours or dollars. If the ratio in one measurement is higher than the other, it is said that "the productivity of labor" is higher, meaning labor in one case made a greater productive input than in the other, and implying, of course, that such labor is therefore entitled to higher pay. The ratio is constructed, and the term "productivity" is defined, so as to trick everyone into believing the impossible has indeed been accomplished. Mature labor workers in the last half of the twentieth century, fully aware of the fact and purpose of technology embodied in capital, are somehow, *as labor workers*, producing more, working harder, or smarter, or something. Capital workers are—and this is the essence of the myth—rigidly and ceremoniously overlooked, although for more than 200 years it has been the capital workers, with their technological tool prodigies harnessing ever more cleverly the laws of nature, that are the chief source of increased productive input and the chief cause of the rising output of goods and services.

Quite obviously, where the input factors combine their efforts to produce a result, either the labor workers or the capital workers or both theoretically *could be* the source of the change. But the facts of life are that since the onset of the Industrial Revolution, and actually since long before that, labor workers have been physically providing less and less productive input, no matter how measured, and capital workers have been physically providing more and more of the productive input. On the part of labor workers, the hours of work, the intensity of toil, and the complexity of tasks have all declined over the years, while vacations, paid holidays, and interludes of leisure on the job have all increased.

On the part of capital workers, technology has relentlessly improved the productiveness of their capital instruments and they have, until the social strife between labor workers and capital workers (and management acting on behalf of capital worker owners) began to interfere, consistently increased their investment in capital instruments by using their "Divine Right—American Style" access to financing.

- 87, 90 -

## The accomplishments of the economists

By fraudulently attributing the rising production and productiveness of capital workers to the rising productiveness of labor workers and calling the result the "rising productivity of labor," the economic shamans accomplish these unbelievable results:

- They make the national economic policy of solving the income distribution problems of the society through labor employment alone appear to be workable when it is not.
- They make necessary the ever-growing redistribution of income from capital workers to non-capital workers and from higher paid labor workers to the lower-paid labor workers and the unemployed. If, for political reasons, the federal government rejects the unpopular redistribution task well, there is always the New Federalism.
- They have saddled us with ever-rising public and private debt, on the one hand, in order to support growing income redistribution, and on the other hand, to warehouse and maintain—in the teeth of inflation—the value of the hoards of morbid capital of the tiny minority of capital worker plutocrats.
- They preoccupy the best minds of the nation in government, business, and finance with trying to solve the great economic problem of achieving both affluent levels of production and a workable distribution of income adequate—under Say's Law—to support such production. When this fails, as it must under one-factor economics, they then recommend "solutions" that only make the problems worse.
- They force the United States of America, a nation once revered as standing for a better world and a better life for each human being, to engage in activities that affront the conscience of individual Americans and threaten our common survival.
- They have destroyed 11/12ths of private property in theoretically privately-owned capital, and are well on the way to finishing the job, just as Marx and Engels predicted 134 years ago in their **Communist Manifesto**.
- By saturating the schools and professions with their one-factor economic falsehoods, they have provided support for the uncontrolled greed of the capital-owning five percent of the population, thus converting the invisible violence of corporate finance into the political and economic alienation of the non-capital-owning majority.[*] From this flows the rising tide of hatred of government, hatred of its leaders, hatred of the social institutions that work for the few but not for the many, and hatred of their own powerless status as wards of welfare, boondoggle, and entitlements.

To paraphrase the late Everett Dirksen, if you add up enough such charges, you begin to make a case for changing our national economic policy.

## The reticence of the rich

The question naturally arises as to why capital owners as such do not take the initiative to destroy a myth that denies their status as the producers of affluence in an industrial economy. The full answer to this question is too laden with psychological undertones to discuss here. But the basic answer is simply this: How does a rich capital worker (plutocrat) explain why he wants to produce goods and services for many people—perhaps millions of people—while consuming for only one or a few—himself and his dependents? How could he square such a desire with Say's Law?[29]

*The Constitution makes citizens, the Congress, and the Judiciary the guardians of democracy: economic as well as political.*

The disastrous fifty-year reign of the one-factor economists should be ended by American citizens, by the Congress, and by the courts, acting under the constitutional mandates. The solution to the income production and distribution problem—how people produce and how they become entitled to consume goods and services in a civilized society—has vast national importance and equally vast international overtones. Its solution cannot be delegated to a tightly disciplined, self-serving, face-saving corps of self-appointed experts who, in effect, decade after decade, control the nation's economy for selfish ends of themselves and the plutocrats that are not only irrational and destructive, but unconstitutional. Here are some of the particulars:

1. The United States was founded as the first great modern experiment in democracy. The importance of democracy to people is that *it is designed to the scale of individual human beings*; not to dynasties, nor to giant corporations that are narrowly rather than broadly owned, nor to other vast ownerless institutions. Democracy was conceived on the idea that power should reside in the individuals who make up a democratic society. But there are two forms of non-violent civil power. Political power, consisting of the power to make, interpret, and administer the laws, and economic power, the power to produce goods and services. Political power and economic power are equally potent. *Neither gives a citizen democratic power without the other.*[30]

Economic democracy cannot be anything except the autonomous power of each individual (or consumer unit) to produce the income equivalent (within the overall limits of the country's resources and technology) of the lifestyle he reasonably chooses for himself and his dependents. In a world in which for 200 years capital workers have been providing a constantly larger proportion of productive input and labor workers have been providing a diminishing proportion of the productive input,[31] economic autonomy, and consequently economic democracy, cannot be achieved without institutions and laws that give effective access to credit to buy capital and to engage in producing income as capital workers to an ever-greater proportion of the population. All laws and institutions that impede or prevent achieving economic democracy abridge both the rights of individual citizens to political democracy and to economic democracy; they transgress individual rights to life, liberty, and equal protection of the laws.

2. Permitting the secret government—the cult of one-factor economists—to preempt the attention, energy, resources, and even to spill the blood of our people in "full employment wars," by distracting the society and its most politically active people into alleviating the *effects* of poverty rather than its cause, does not fulfill the Congressional duty, or the duty of citizens, to seek and find economic democracy as a component of each citizen's total of democratic power. The accomplishment of that task through Social Capitalism will be astonishingly simple when compared to the stonewall impossibility of achieving democratic goals through redistributing—as labor workers' income and as welfare—the income largely and increasingly produced by plutocratically owned capital.

3. The deceptive questions of the one-factor economists should be dismissed from the national economic debate, and replaced with rational questions capable of leading to sound answers:

a. We should ask "why are people poor?" rather than "how can we alleviate the effects of poverty?" The right question almost instantly evokes the right answer. *People are poor because they don't own enough capital.*

b. We must stop asking "how can we redistribute more income to the poor in order to enable them to enjoy the benefits of science and technology?" and ask "how can we phase out poverty and redistribution of income of every variety and achieve economic autonomy?" The right question leads to the answer of Social Capitalism: a capitalist economy that works for every citizen, not just for rich citizens. After two centuries of business financing built upon the Divine Right of Kings—American Style, the Employee Stock Ownership Plan (ESOP) was literally introduced to Congress in 1973 by a "Dear Colleague" letter from Senator Mark Hatfield, working in collaboration with Senator Russell Long, then chairman of the Senate Finance Committee. That letter, pertaining to the Northeast Rail Reorganization, dated November 5, 1973, set forth the first, and to date the only, significantly implemented technique of corporate finance that conforms to our constitutional mandates of the right of every citizen to life, liberty, and equal protection of the laws, and the right not to be deprived, through technology, of his productiveness as a labor worker without the "due process" of an effective opportunity to become even more productive as a capital worker. The outcry of the one-factor economists to the ESOP provisions of the Penn Central financing legislation was predictably unanimous: "Capital theory is nonsense" and "even if it is logical, it won't work," etc. They effectively frustrated implementation of the Congressional enactment.

Because Congress did not suspect the collaboration between the self-interest of the one-factor economists and the barons of morbid capital, it failed to adopt measures to prevent them from fraudulently frustrating the intent of the Penn Central bill, namely that government funding of the rail reorganization be loaned to the new corporation through an ESOP covering all employees. The result has been an economic disaster. Annually, additional billions of dollars that will never be repaid have been appropriated to keep Amtrak alive. Featherbedding has continued. The stock and bond holders of the bankrupt railroad made off with the corporate shell, the tax loss carries forward, and sufficient assets to again put the corporation almost overnight, under plutocratic ownership, among the leaders of the Fortune 500.

Because the one-factor economists naturally wish to preserve their decades-old control of the American economy and to save their faces and their multi-billions of dollars of income and perquisites, they monitor the faculties and publications of every business school, every law school, the economics, political science and philosophy departments of every university, and the educational institutions operated by every professional and trade association in the country. They use their status as "experts" to censor Social Capitalist thought from all publications dealing with or even touching upon economic matters, thus effectively keeping Americans in ignorance of the Social Capitalist alternative and perpetuating the one-factor fraud.

c. We alluded earlier to the fact that one-factor economics knows only one proven way to terminate a depression: war preparation. In view of this, the "full employment" potential of war through the Reagan Administration's military build-up toward global suicide is not without significance. The

only way to significantly increase labor employment and magnify the morbid capital of the owners of munitions plants, in the face of a diminishing demand for consumer goods and services produced by labor, is to produce goods and services that do not depend upon purchase by consumers spending their own shrinking labor and welfare incomes. Military goods and services sold to taxpayers through deficit financing and taxation are the one-factor economists' answer, notwithstanding the fact that war between the United States and Russia is as obsolete (because it is suicidal) as the dinosaur.

The fact is, Russia is in an impossible posture, and we are making its political compatibility with the United States even more difficult. Russia cannot yield to the pressures to democratize its institutions (such as those in Poland and Afghanistan) while it is nominally in the ridiculous "dictatorship of the proletariat" phase of socialist development any more than we can democratize the United States or lead any Third World country to honest economic development through economic democracy so long as the one-factor economists hold our minds in bondage.[32] Karl Marx, to whom the Russians pay lip service, was passionately looking for the kind of full human freedom for individuals that can be achieved only under Social Capitalism. Until the United States can establish a model policy that is both rational and practical and conforms to the prescriptions of its own Constitution, it cannot be expected to favorably influence the policy or institutions of Russia or of any other nation.

As for U.S. governmental measures aimed at weakening the Russian economy, we would do well to remember the results of similar measures used on Germany after World War I.

Although ideas can be destroyed only by better ideas, the predicament of the cult of one-factor economists is such that they see no way to save their faces while permitting a better idea—Social Capitalism—to become national economic policy in the United States. Fortunately, Congress' responsibilities and those of U.S. citizens in general in this matter rest upon the Constitution and not upon the *ex cathedra* myths and pontifications of a defunct economics priesthood.

## Can our national economic policy of full employment be made to work?

Yes, if we would but make peace with reality and acknowledge that there are *two* ways in which people can work and earn income, i.e., engage in economic production. One is through their privately owned labor power, as labor workers, and the other is through their privately owned capital, as capital workers. Economic autonomy, the natural economic goal of a political democracy, implies that everyone be engaged in producing the standard of living he wishes to enjoy. This is full employment in the two-factor sense of the word and the sense that J. B. Say intuitively understood. Economic democracy cannot be found where the few produce for the many, for that is the kind of economic imperialism that weakens, trivializes, and enslaves the underproductive majority.[33]

As a practical matter, at our stage of technological development, if the value of labor inputs and capital inputs into the economy were both competitively evaluated, it is quite possible that only a few labor-worker geniuses, like Thomas Edison or the Beatles, could produce a satisfactory level of income unaided by capital ownership. Thus everyone needs a growing holding of revitalized capital.

*Implementing Social Capitalism—the eight financing tools for implementing transition to a Social Capitalist economy.*

The basic financing tools to implement capital theory have been designed and their logic has been tested operationally over a 25 year period, *because each implementing tool is constructed on the logic embodied in a properly-designed ESOP.* This logic testing through the ESOP has been accomplished under extremely adverse—actually hostile—environmental conditions; conditions that Social Capitalism would eliminate. The eight implementing tools are:

*ESOP: Employee Stock Ownership Plan.* The ESOP is designed to build capital ownership into employees of a business in the course of efficiently financing its growth or other desirable corporate objectives, without deductions from paychecks or invasion of savings of employees. As to employees, the ESOP is that constitutionally-mandated missing link that gives them access to credit to buy the employer's capital stock and, without personal risk or liability, to pay for it from the pre-tax earnings of the assets underlying that stock; in other words, equalizing their access to capital credit with the already rich. Estimates place the number of operating ESOPs at more than 5,000.

*MUSOC: Mutual Stock Ownership Corporation.* This financing method is intended to provide pooled ESOP financing for a number of corporations while building *diversified portfolios of their stocks* individually into the employees of each.

*CSOC: Consumer Stock Ownership Corporation.* This technique is intended for use in public utilities, banks, insurance companies, and other businesses where long-term relationships between a producer and its customers are the rule. Through the intelligent use of credit, it builds capital ownership into customers while providing unlimited low-cost financing for growth of the corporation, thus raising the power of the consumers to pay for their purchases of goods and services while raising the power of the corporation to produce goods and services. It would normally be used in conjunction with an ESOP for employees.

*GSOC: General Stock Ownership Corporation.* Designed to build capital ownership into politically designated classes of consumers within the jurisdiction of the authorizing government—state, local, or federal. While it is in need of several amendments, a GSOC law was enacted by Congress in 1978 as Subchapter U of the Internal Revenue Code.

*ICOP: Individual Capital Ownership Plan.* A financing device intended to create viable capital estates individually in governmentally selected categories of qualifying individuals while opening broad markets for equity financings by corporations.

*RECOP: Residential Capital Ownership Plan.* This financing plan, in combination with pure credit financing, would enable home buyers to purchase homes at less than 25 percent of the out-of-pocket principal and interest cost of similar transactions today, by having their acquisitions treated by tax and other relevant laws as capital assets, rather than as consumer items as at present.

continued

**Productive** *continued*

*COMCOP: Commercial Capital Ownership Plan.* Ownership of rental structures, such as office and apartment buildings, factories, mines, railroads, hotels, resorts, etc., is a major source of capital cash income. Today such structures and real estate generally are owned by the excessively wealthy (whose resulting income is thereby sterilized for purposes of the consumer economy and denied to those who could use it if the financing had been COMCOP structured), who use such acquisitions not only to satisfy their anti-social greed, but to wipe out their income taxes. COMCOP would enable commercial structure ownership legitimately to be spread over large numbers of people where it can raise their power to produce the incomes they need to make them powerful and self-supporting consumers, satisfy their lifestyles, and diversify their holdings in businesses in which they become employed as capital workers.

*PUBCOP: Public Capital Ownership Plan.* This plan is designed to provide low-cost financing for capital instruments used by public bodies of all types—office buildings, streets and sidewalks, parks, street lighting, schools, universities, subways, waterworks, harbors, etc. It permits broad individual ownership, through facilities corporations, by great numbers of people, while providing low-cost capital facilities to be leased at market rates to cities and other municipal corporations, states, the federal government, and other public bodies. PUBCOP is another tool in the arsenal of Social Capitalism to assure that each individual can become employed as a capital worker and that governments do not acquire economic power that should be owned in reasonably-sized holdings by citizens. PUBCOP financing would employ the dual functions of other capital financing devices and would be a major means of eliminating the cost of wasteful, inefficient, and inadequate public employee pensions, while providing much greater economic security and incomes, both before and after retirement, to public employees and others.

## Pure credit for capital financing

This is a rational method of providing money for capital acquisitions by using more intensively and logically the feasibility principle of traditional finance, and substituting commercial risk insurance for our current unconstitutional but dominant use of the borrower's collateral to provide such risk insurance. [14] Such a financing source is necessary to accomplish the transition from our pre-capitalist economy to a Social Capitalist economy and to enable the economy to operate thereafter at full power. Not only would this dispense with the crippling mythology of the one-factor economists that high interest (a major cause of inflation) is necessary to control inflation, but it would enable us to restore the integrity of private property to the ownership of capital.[15] *The broadening of capital ownership will not bring about economic democracy unless the full wages of capital are paid regularly and fully to the owners of capital.* Pure credit not only makes this possible, but it restores integrity and usefulness to Say's Law. Supply can create its own demand if our business and financial institutions are operated so as to substantially eliminate morbid capital and match the unsatisfied needs and wants of individuals to increases in their productive power.

## Social capitalist financing and the business cycle

The economic needs and wants of civilized people do not fluctuate, but gradually rise and then stabilize at a point that supports their lifestyles. The power of a resource-rich and trading-competent economy like that of the United States to produce goods and services does not fluctuate, but rises steadily and indefinitely towards a theoretical state which we might identify as "solid-state affluence." Thus it is clear that business cycles are man-made; the result of avoidable mistakes, not natural phenomena as the one-factor economists would have us believe.

Consequently, by insuring the risk of non-feasibility through casualty insurance techniques, we would not only end the cause of future accumulations of morbid capital and achieve a logical and workable economy, but we would make the use of capital financing tools easy and effective. Granted that from the historic experience with FHA Housing Insurance, Federal Deposit Insurance Corporation insurance, and other similar applications of the casualty insurance principle, the Capital Diffusion Insurance Corporation probably should be initially established as a government corporation. But this precedent should soon be imitated by private underwriters, just as in the case of MGIC insurance which was organized to compete, and does successfully compete, with FHA. This should be one of the greatest untapped insurance product markets ever. Indeed, most life insurance itself is justifiable only on the basis of the soundness of one-factor economics, perhaps another reason why we have resistance to two-factor theory. Financial feasibility insurance in transactions involving the use of pure credit will prove to be both easy and inexpensive from the standpoint of the borrower, and very profitable for the seller. Our estimate is that the average premium eventually will not exceed one-quarter of one percent per year.

Diagram B shows how, in general, pure credit and commercial feasibility risk insurance would function in connection with use of any of the eight implementing tools designed to effect transition to a Social Capitalist economy, and to finance the operations of the economy thereafter.

## Summary

Social Capitalism, and the right of each citizen to life, liberty, and equal protection of the laws under the United States Constitution, requires:

a. Adoption of a Social Capitalist national economic policy to enable those who are not already capital workers to become capital workers by means using the logic underlying the ESOP. The ESOP and the seven other financing techniques blueprinted in Social Capitalism are *simultaneously* capable of (1) financing every type of capital requirement of commerce, industry, and government (except military goods which in their nature are not producer goods and do not pay for themselves), and *in the same transactions* and *with the same dollars*, (2) making millions upon millions of new capital workers. These steps, together with (3) the hardening of the laws of property so that capital workers collect the full wages of their capital, and (4) general availability of low-cost pure credit for financing individual capital acquisition, will put the economy on a sustained upward growth curve. These steps will not only fulfill the constitutional right of every citizen to *economic* as well as *political* democracy, but will raise the income-earning power of individuals who need and want to consume more goods and services, rather than merely the incomes of those who can only use more income to acquire *more excess* sterile productive power, i.e., more morbid capital.

b. A national economic policy based on capital theory requires legislatively implementing the use of pure credit. The

simple mechanics of pure credit were first described in 1961 in **The New Capitalists** by Kelso and Adler. Pure credit was again explained in a 1974 paper prepared for President Gerald Ford's Inflation Summit Meeting, titled "A New Economic Policy to Meet the Needs of the American People and of the U.S. Economy."[10] The average effective interest *cost to the borrowers* of such capital-financing credit, where Congress authorizes its use, should not significantly exceed two percent, and aggregate credit availability would be limited only by the economic feasibility of the asset growth thus financed. Neither the federal government's credit, nor its accounting, nor government guarantees would be involved. Pure credit links growth of the economic power to produce with growth of the power to consume of those with unsatisfied needs and wants by enabling them to become capital workers and to produce higher incomes.

c. Pure credit can be used selectively at first, as for financing ESOPs, or for the housing industry, or for effecting the sale of the twenty-two operating telephone subsidiaries recently ordered to be divested by AT&T to their consumers (through Consumer Stock Ownership Plan—CSOP—financing) and to their employees through ESOPs. Its initial use might also include the privatizing of publicly-owned assets like the U.S. Post Office, the Tennessee Valley Authority, and the capital assets of federal, state and local governments, particularly where they are in financial trouble.

## Plutocratic savings vs. democratic savings

Functionally, of course, all producer goods (real capital) and cash or liquid assets that can be readily converted into producer goods, are "savings." The important distinction, however, for purposes of understanding capital theory and the use of pure credit, is the distinction between plutocratic savings and democratic savings.

Plutocratic savings are real capital (or liquid assets that can be readily converted into real capital) that produces for its owners income they cannot, because of their own physical, moral or intellectual restraints, use to support their *consumer lifestyles*. In other words, plutocratic savings are morbid capital.

Democratic savings are savings (capital) that are fully used by the owners to provide income for consumption and enjoyment for them and their dependents.

Democratic savings are healthy. Plutocratic savings are the biological equivalent of cancer: a thing that grows relentlessly out of symbiotic relation to the organism to which it is attached.

The 193-year reign of economic plutocracy in the United States will begin to disappear as quickly as our national economic policy is changed to one based on Social Capitalism[11] and the tools for implementing Social Capitalism and the use of pure credit are legislatively authorized.

## Money and banking under economic democracy

Modern banking systems are built primarily on the idea that capital transactions can be financed only through the use of accumulated savings or morbid capital. This idea is the very heart of the Divine Right of Kings—American Style. Used in parallel with this false idea is the associated belief that life, liberty, and equal protection of the laws under the American Constitution can be satisfied through equal opportunity (and equal liability, as the Marxists openly, and we covertly, insist) of all who do not own capital to toil. Democratic enlightenment, on the other hand, holds that each citizen has a right and duty to support himself and his dependents through participation in production as a labor worker, or as a capital worker, or both. Fortunately, the economy of the United States and its existing institutions can operate far more efficiently and smoothly under a Social Capitalist economic policy than under a one-factor economic policy. The use of morbid capital savings that frustrate almost every healthy aspect of the economy would end in time as capital ownership begins to grow where it is useful and needed rather than where, contrary to the laws of property and to the clear mandate of the U.S. Constitution, it economically handicaps individuals and injures the public interest. We have the institutions necessary to make a Social Capitalist economy work; the parts are in place. We need merely correct their present misuse and our erroneous national economic policy that supports such misuse.

Pure credit, like traditional capital credit, is implemented through contractual relationships, often a complicated web of contracts, amounting in effect to a refined and rationalized barter system. It involves in each contractual web the owners, sellers, or builders of capital goods, the buyers and users of capital goods, and the labor workers and capital workers who produce capital goods and consumer goods and services.[12] Each individual who participates in production as a labor worker, a capital worker, or in both capacities, contributes goods and services (productive inputs) into the economy in exchange for equal value, competitively determined and measured in money units, of other goods and services produced by others. Under primitive barter, goods and services themselves are exchanged, and so an in-kind barter system can only be used in the simplest of economies. The use of money changes the form of barter from goods and services in return for goods and services, to goods and services in return for money and then again through money to goods and services. In toto, the process of sophisticated barter through the use of pure credit can be described as individual production of goods and services which translates into money, which in turn translates into individual use of money to purchase for consumption of goods and services produced by others.

## Conclusion

Only the American people, exercising their political rights, and their duly elected representatives in Congress can rescue the economy of the United States from a potentially fatal depression, and from creating a one-factor full-employment war that would suspend civilization for several hundred thousand years. Only they can rescue the American society from its economic hypocrisy, from its retreat from greatness, and from its failure to fulfill its promise to the world and to the American people to maintain the torch of democracy—political democracy foundationed upon economic democracy.

Miraculously, we have within our grasp all the ingredients, including, very importantly, the institutional infrastructure. We need only courageous citizens and legislators to initiate the change, a courageous judiciary, and a clear-eyed executive to complete the task.

Abraham Lincoln said that the purpose of government is to do for the people what they cannot do for themselves. The task we here urge upon Americans and upon Congress—the adoption of a national economic policy of Social Capitalism and the adoption of legislation to implement that policy accompanied by the thoughtful analysis and debate that is required to minimize error—is, we are confident, the kind of task that Mr. Lincoln had in mind.

In the words John Stuart Mill used to conclude his *Essay On Liberty*:

> "A government cannot have too much of the kind of activity which does not impede, but aids and stimulates, individual exertion and development. The mischief begins when, instead of calling forth the activity and power of individuals and bodies, it substitutes its own action for theirs; when, instead of informing, advising, and, upon occasion, denouncing, it makes

them work in fetters, or bids them stand aside and does their work instead of them. The worth of a State, in the long run, is the worth of the individuals composing it . . . a State which dwarfs its men, in order that they may be more docile instruments in its hands even for beneficial purposes—will find that with small men no great thing can really be accomplished; and that the perfection of machinery to which it has sacrificed everything will in the end avail it nothing, for want of the vital power which, in order that the machine might work more smoothly, it has preferred to banish."

**Footnotes**

(1) The term is Professor Paul Samuelson's.

(2) Pope Leo XIII, Encyclical Letter on the Condition of Labor.

(3) See Footnote (15).

(4) See Diagram E.

(5) See Diagram A.

(6) See Diagram C and D.

(7) See Diagram C and D and J. S. Mill quote.

(8) See **The New Capitalists**, Kelso and Adler.

(9) See Diagram B.

(10) Today's high interest rates reflect the risks inherent in an economy that heavily relies upon strife-laden redistribution to get minimal income to those with unsatisfied consumer needs and wants, and the high cost of insuring warehoused morbid capital against inflation.

(11) See "Pure credit for capital financing."

(12) State and federal corporate income taxes, together with the employer's share of Social Security taxes, on the average take over 50 percent of corporate income. Boards of directors, lacking a rational method for financing corporate growth, then take from stockholders ⅓ths of the after-tax income remaining. Minor leaks in the property pipeline running from assets to stockholders reduce this trickle from less than ⅓th to ⅓th.

(13) The Employment Act of 1946.

(14) i.e., the handicapped potential members of the capital work force (the total population), kept in that condition by the Divine Right of Kings— American Style.

(15) Blake's Law:

> He who would do good to another must do it in Minute Particulars. General Good is the plea of the scoundrel, hypocrite and flatterer, For Art and Science cannot exist but in minutely organized Particulars.
>
> —William Blake (1757-1827)

(16) See Diagram E.

(17) Politically, citizens have the right to be productive—economically autonomous. But competition and the state of technology, not the law or the sociologists, determine how production should be carried on.

(18) See Diagram E.

(19) To interpret the "inalienable" constitutional right to life as merely being a right to biological life as a parasite would certainly be grounds, under the clear language of the Declaration of Independence, for abolishing our government and instituting a new one that would give us both political and economic democracy. In other words, a one-factor national economic policy, rather than a Social Capitalist national economic policy, puts us in the legally and morally untenable position of *de facto* trying to alienate capitalless citizens from the "inalienable" right to life and liberty in what should be a political and economic democracy.

(20) See Diagram E.

(21) See Diagram C and D.

(22) Harold Moulton, **The Formation of Capital**, The Brookings Institution, Washington, D.C., 1935, Page 1.

(23) W. J. Ballinger of the Federal Trade Commission, in his testimony before the Temporary National Economic Committee (Hearings, Part 9, Page 3833).

(24) Paul G. Hoffman, President of Studebaker Corporation and Chairman of the Board of Trustees of the Committee for Economic Development, in Hearings on S. 380, the Full Employment Act of 1945, before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, 79th Congress, First Session, July-September 1945, Page 709.

(25) Id., Page 845.

(26) After all, economics, while not the most important thing in life, has been at all times past the *most urgent*, and one factor economics itself, by making the economy progressively more unworkable, enhances this urgency.

(27) For example, our Korean and Vietnam wars, the primary purpose of which were to support full employment and stave off depression.

(28) As ever more people lose this battle for survival in the world of law and order, they turn to the underground economy where risks are higher but rewards are greater and capital credit is frequently more accessible. See "The Invisible Violence of Corporate Finance," Kelso and Hetter, *Washington Post*, June 18, 1972, Appendix I, Page 45, post.

(29) See Diagram C and D.

(30) See Diagram A.

(31) See Diagram E.

(32) The entire "human rights" posture of the U.S. government is crass hypocrisy so long as our national economic policy in fact denies economic democracy to 95 percent of our own citizens and causes us to set a disastrous example for the world.

(33) See the quotation from John Stuart Mill's *On Liberty*.

(34) See the use of a Capital Diffusion Insurance Corporation in Diagram B.

(35) High interest *is necessary*, of course, to protect vast holdings of morbid capital against inflation, and to allay the owners' "expectations" that future inflation will be even higher.

(36) See "Proposals to the President." In the 1974 paper for the Economic Summit Meeting on Inflation, and in earlier writings, out of an excess of caution we suggested confining the use of pure credit financing to new capital formation. Clearly that is an unnecessary precaution given the monumental problems of broadening capital ownership, accelerating the rate of economic growth, and raising the *earning* power of economically underpowered consumers. Every capital acquisition by well-managed businesses, whether of newly-formed capital or not, must pass feasibility tests.

(37) See Diagram B.

(38) See Diagram B.

## EXHIBIT II
## AN ACT TO AMEND THE NATIONAL ECONOMIC POLICY

**AN ACT To amend the national policy on employment, production, and purchasing power, and for other purposes, as set forth in the Employment Act of 1946, as amended.**

WHEREAS, the rate of change in the production of useful goods and services from labor intensive to capital intensive since the adoption of the Employment Act of 1946 has continued to accelerate, and people who participate in production and earn income through their privately-owned capital (land, structures, machines, and capital intangibles, normally represented by corporate stock) now provide a dominant and increasing proportion of the productive input — if measured on the assumption of free market forces — while people who participate in production and earn income through their labor power provide a minor and diminishing proportion of the economic input; and

WHEREAS, the ownership of the great bulk of nonresidential capital in the U.S. economy lies in the top five percent of individual wealthholders, primarily as the result of long established capital financing practices which constrict access to capital credit to borrowers who are already substantial owners of capital, thus denying access to significant capital credit and equal protection of the laws to the capitalless 95 percent of the population; and

WHEREAS, Congress, for ten years, has been experimenting with a method of capital financing known as Employee Stock Ownership Plan "ESOP" financing, which makes available to corporate employees capital credit with which they can purchase their employer's stock and pay for it out of the pre-tax yield of the assets represented by that stock, while simultaneously providing highly efficient asset financing for the employer corporation and its existing shareholders; and

WHEREAS, other methods based on the logic of ESOP financing have been developed and can be legislatively implemented by Congress and by the state legislatures, for the purpose of enabling consumers generally, over a reasonable period of years, to become capital workers and to earn capital-derived incomes in the course of providing efficient, low-cost financing to accelerate the growth of both privately and publicly used capital, thus reducing not only labor worker unemployment, currently estimated at around eight percent of the labor force, but capital worker unemployment, currently estimated at 95 percent of the potential capital work force; and

WHEREAS, Congress finds that raising the earning power of the great majority of economically underpowered consumers of the United States is a more logical solution to the principal economic problems that confront the nation today than redistributing income from those who earn it to those who need it, through taxation, transfer payments, legislating of wage rates, and the subsidizing of economic activities of many kinds, all of which contribute to the growth of national debt, annual budgetary deficits, trade deficits, inflation, depressed economic growth, widespread areas of poverty, loss in the production of goods and services to lower cost foreign competitors, and to labor unrest and social turmoil; and

WHEREAS, Congress hereby recognizes its constitutional duty to insure each citizen's rights to life, liberty and the pursuit of economic happiness, by providing maximum reasonable opportunity to earn, either as a labor worker, or as a capital worker, or in both capacities, the income necessary to support a comfortable and reasonable lifestyle; that the question of which of the alternative ways to participate in tion and earn income is appropriate for particular citizens under particular

circumstances is not a governmental, moral, or political matter, but one that must be made by the individuals immediately concerned in each instance on the basis of economic, scientific, technological, engineering, managerial, labor relations, cost accounting, market competitiveness, and human leisure and happiness considerations; that governments should be neutral as to whether people earn their incomes as labor workers, capital workers, or in both capacities, but should adopt all reasonable means to assure each consumer unit's right to be economically self-supporting;

NOW, THEREFORE, Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled:

## AMENDED DECLARATION OF POLICY

"Section 1. The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture **banking, finance,** labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, **as labor workers and as capital workers, for all consumers desiring economic autonomy and self-sufficiency,** and to promote maximum employment **as labor workers, or as capital workers, or in both capacities, and maximum production and purchasing power."**

## STATEMENT OF JOHN HOUSTON, LEGISLATIVE DIRECTOR, FREE THE EAGLE CITIZEN'S LOBBY, WASHINGTON, DC

Mr. HOUSTON. Thank you very much. My name is John Charles Houston. I am an attorney and the legislative director of Free the Eagle. Free the Eagle is a grassroots citizens' lobby which has 265,000 Members across the country. Free the Eagle was created in 1980, and it is concerned with working with all Members of Congress so that they can represent their constituents more effectively on matters dealing with free markets, stable currencies, sound domestic and foreign policies. Under the current Tax Code, individuals have the option of listing all their deductions on the 1040 form, or using the 1040A or 1040EZ forms.

Our proposal would allow all taxpayers the option of using the 1040 with its deductions or the 1040A or its equivalent by using the maximum tax rate of up to 20 percent. This will eliminate the enormous expense and waste of recordkeeping, time loss, nonproductive shelters, deductions and exemptions needed to file an honest tax return, for those who choose to use this option. Today, Americans are spending billions of dollars on tax lawyers, accountants, and tax preparers in a manner that is nonproductive. It is fair to say that filing one's income taxes is one of the greatest sources of irritation to the American public. There is evidence that many people would gladly pay a higher rate of taxes by giving up their deductions, just to be free from the hassles of the present system.

In the course of observing the debate on tax reform, we have come to the conclusion that there is general agreement that the Tax Code is too complicated, has become the playground of special interests, and discourages productive economic activity. We have observed that there is a surprising degree of unanimity on this, after discussing these problems with the Tax Code with members of the House Ways and Means Committee and the Senate Finance Committee. Virtually everyone agrees that an understandable code with fewer deductions and fewer rates is an improvement that could and should be made. Taxpayers pay a fortune for our present system. Individual taxpayers face more regulations and unfair guidelines than any special interest group in America today. And they are so intimidated from hassles and audits that they are becoming ever more discouraged and even afraid to do tax preparation by themselves. As an example of the waste in the present system, the dollar cost of complying with the present code is conservatively estimated at $17 billion a year. The cost in intimidation, recordkeeping, and IRS audits is a much higher figure. The value of escaping the costs of accountants, lawyers, and other preparers would allow the Government to raise even more revenue than the present code does. Those with higher incomes who devote substantial time and money to recordkeeping and legal and accounting services would find it easier to simply earn and report more income.

A majority of those in Congress who have endorsed some type of tax reform bill have sponsored some type of flat tax legislation. Flat taxes have become a buzzword for reform, yet it seems that once again the debate is leaving its primary objective for the sake

of special interest groups, and it is occurring at the expense of the individual taxpayers. The original Federal income tax was a flat tax. With a few fixed rates and no deductions, it was possible for taxpayers to easily predict their tax bill a year in advance. This tax structure was fair, understandable, and simple. Both the American people and Congress appreciated its obvious merits. Today, the issue has gone full circle, and the American people once again want a tax that is fair, understandable, and simple. But how can Congress make that which is politically desirable politically feasible? Free the Eagle proposes an alternative tax proposal that the administration and congressional tax proposals have not addressed. We propose to give taxpayers a choice between using the current tax system, with its high rates, many deductions, and complicated tax forms, or a flat tax with no deductions, much lower rates, and simple tax forms. We propose an optional flat tax on gross income with no deductions for those who want to get off the deduction treadmill. We believe everyone has overlooked the obvious. We already have a simplified tax plan in the Tax Code. It is not necessary to scrap the current law or close all the loopholes to institute a simplified flat tax. All Congress need do is provide an incentive for all taxpayers to use the simple Federal tax forms that already exist. The forms are the 1040A, known as the short form; and for those who are single and have no dependents, the 1040EZ. The short form is so simple and understandable that millions of Americans fill it out every year without the help of a taxpreparer. Last year more than 60 percent of all taxpayers used it.

We propose that Congress add the following sentence to the Tax Code: "Taxpayers who file a 1040A or 1040EZ or its equivalent would be required to pay a maximum of 20 percent of their gross income." This is based on statistics which we have received from Polyeconomics and other authorities on the economics of taxation. The average effective rate now paid by those earning $50,000 to $75,000 a year in gross income is 18.2 percent. Lower tax rates for lower income groups under current law would still apply. The optional flat tax is a maximum tax and not a minimum tax, so it would not cause any harm to the poor. By way of comparison, this would allow some taxpayers to opt for an equal or higher rate of taxes for the privilege of simplicity and doing away with the whole recordkeeping/audit function. I can see that we are running short of time. If I could just point out a couple of examples that other countries have adopted this sort of optional tax. They have a marginal tax rate and then they have a maximum tax rate. They include Hong Kong, which has a marginal rate of 25 percent and a maximum rate of 17 percent; Switzerland, which has a marginal rate of 13 percent and a maximum rate of 11.5 percent; and the State of New Jersey has adopted this or a similar concept for their State tax. Thank you.

Senator SYMMS. Thank you very much, Mr. Houston.

[The prepared written statement of Mr. Houston follows:]

**TESTIMONY OF JOHN CHARLES HOUSTON, ESQUIRE, LEGISLATIVE DIRECTOR OF FREE THE EAGLE CITIZEN'S LOBBY BEFORE THE SENATE FINANCE COMMITTEE, OCTOBER 10, 1985.**

MY NAME IS JOHN CHARLES HOUSTON. I AM AN ATTORNEY AND THE LEGISLATIVE DIRECTOR OF FREE THE EAGLE. FREE THE EAGLE IS A GRASS ROOTS CITIZENS' LOBBY WHICH HAS 265,000 MEMBERS ACROSS THE COUNTRY.

FREE THE EAGLE WAS CREATED IN 1980. IT IS CONCERNED WITH WORKING WITH ALL MEMBERS OF CONGRESS SO THAT THEY WILL REPRESENT THEIR CONSTITUENTS MORE EFFECTIVELY ON MATTERS DEALING WITH FREE MARKETS, STABLE CURRENCIES, AND SOUND DOMESTIC AND FOREIGN POLICIES.

UNDER THE CURRENT TAX CODE INDIVIDUALS HAVE THE OPTION OF LISTING ALL THEIR DEDUCTIONS ON THE 1040 FORM OR USING THE SHORT 1040A AND 1040EZ FORMS. OUR PROPOSAL ALLOWS ALL TAXPAYERS THE OPTION OF USING THE 1040 WITH ITS DEDUCTIONS OR THE 1040A OR ITS EQUIVALENT BY USING A MAXIMUM TAX RATE OF UP TO 20 PERCENT. THIS WILL ELIMINATE THE ENORMOUS EXPENSE AND WASTE OF RECORD KEEPING, TIME LOSS, NON-PRODUCTIVE SHELTERS, DEDUCTIONS, AND EXEMPTIONS NEEDED TO FILE AN HONEST TAX RETURN FOR THOSE WHO CHOOSE TO USE THIS OPTION. TODAY AMERICANS ARE SPENDING BILLIONS OF DOLLARS ON TAX LAWYERS, ACCOUNTANTS, AND TAX PREPARERS IN A MANNER THAT IS NON-PRODUCTIVE. IT IS FAIR TO SAY THAT FILING ONE'S INCOME TAXES IS ONE OF THE GREATEST SOURCES OF IRRITATION

TO THE AMERICAN PUBLIC. THERE IS EVIDENCE THAT MANY PEOPLE WOULD GLADLY PAY A GREATER RATE OF TAXES BY GIVING UP THEIR DEDUCTIONS JUST TO BE FREE FROM THE HASSLES OF THE PRESENT SYSTEM.

IN THE COURSE OF OBSERVING THE DEBATE ON TAX REFORM, WE HAVE COME TO THE CONCLUSION THAT THERE IS GENERAL AGREEMENT THAT THE TAX CODE IS TOO COMPLICATED, HAS BECOME THE PLAYGROUND OF SPECIAL INTERESTS, AND DISCOURAGES PRODUCTIVE ECONOMIC ACTIVITY.

WE HAVE OBSERVED THAT THERE IS A SURPRISING DEGREE OF UNANIMITY ON THIS, AFTER DISCUSSING THESE PROBLEMS WITH THE TAX CODE WITH MEMBERS OF THE HOUSE WAYS AND MEANS COMMITTEE AND THE SENATE FINANCE COMMITTEE. VIRTUALLY EVERYONE AGREES THAT AN UNDERSTANDABLE CODE WITH FEWER DEDUCTIONS AND FEWER RATES IS AN IMPROVEMENT THAT COULD AND SHOULD BE MADE.

## DEREGULATE TAXPAYERS

TAXPAYERS PAY A FORTUNE FOR OUR PRESENT SYSTEM. THE INDIVIDUAL TAXPAYERS FACE MORE REGULATIONS AND UNFAIR GUIDELINES THAN ANY SPECIAL INTEREST GROUP IN AMERICA TODAY. THEY ARE SO INTIMIDATED FROM HASSLES AND AUDITS THAT THEY ARE BECOMING EVER MORE DISCOURAGED AND EVEN AFRAID TO DO TAX PREPARATION BY THEMSELVES.

AS AN EXAMPLE OF THE WASTE IN THE PRESENT SYSTEM, THE DOLLAR COST OF COMPLYING WITH THE PRESENT CODE IS CONSERVATIVELY ESTIMATED AT $17 BILLION A YEAR. THE COST IN INTIMIDATION, RECORD KEEPING, AND I.R.S. AUDITS IS A MUCH HIGHER FIGURE. THE VALUE OF ESCAPING THE COSTS OF ACCOUNTANTS, LAWYERS, AND OTHER PREPARERS WOULD ALLOW THE GOVERNMENT TO RAISE EVEN MORE REVENUE THAN THE PRESENT CODE DOES. THOSE WITH HIGHER INCOMES WHO DEVOTE SUBSTANTIAL TIME AND MONEY TO RECORD-KEEPING, AND LEGAL AND ACCOUNTING SERVICES WOULD FIND IT EASIER TO SIMPLY EARN AND REPORT MORE INCOME.

A MAJORITY OF THOSE IN THE CONGRESS WHO HAVE ENDORSED SOME TYPE OF TAX REFORM BILL HAVE SPONSORED SOME TYPE OF FLAT TAX LEGISLATION. "FLAT TAXES" HAVE BECOME BUZZ WORDS FOR REFORM, YET IT SEEMS THAT ONCE AGAIN THE DEBATE IS LEAVING ITS PRIMARY OBJECTIVE FOR THE SAKE OF SPECIAL INTEREST GROUPS, AND IT IS OCCURRING AT THE EXPENSE OF THE INDIVIDUAL TAXPAYERS.

THE ORIGINAL FEDERAL INCOME TAX WAS A FLAT TAX. WITH A FEW FIXED RATES AND NO DEDUCTIONS, IT WAS POSSIBLE FOR TAXPAYERS TO EASILY PREDICT THEIR TAX BILL A YEAR IN ADVANCE. THIS TAX STRUCTURE WAS FAIR, UNDERSTANDABLE, AND SIMPLE. BOTH THE AMERICAN PEOPLE AND CONGRESS APPRECIATED ITS OBVIOUS MERITS.

TODAY THE ISSUE HAS GONE FULL CIRCLE, AND THE AMERICAN PEOPLE ONCE AGAIN WANT A TAX THAT IS FAIR, UNDERSTANDABLE, AND SIMPLE. BUT HOW CAN CONGRESS AGAIN MAKE THAT WHICH IS POLITICALLY DESIRABLE POLITICALLY FEASIBLE?

## AN OPTIONAL FLAT TAX

FREE THE EAGLE PROPOSES AN ALTERNATIVE TAX PROPOSAL THAT THE ADMINISTRATION AND CONGRESSIONAL TAX PROPOSALS HAVE NOT ADDRESSED. WE PROPOSE TO GIVE TAXPAYERS A CHOICE BETWEEN USING THE CURRENT TAX SYSTEM, WITH ITS HIGH RATES, MANY DEDUCTIONS, AND COMPLICATED TAX FORMS; OR A FLAT TAX, WITH NO DEDUCTIONS, MUCH LOWER RATES, AND SIMPLE TAX FORMS. WE PROPOSE AN OPTIONAL FLAT TAX ON GROSS INCOME WITH NO DEDUCTIONS, FOR THOSE WHO WANT TO GET OFF THE DEDUCTION TREADMILL.

WE BELIEVE EVERYONE HAS OVERLOOKED THE OBVIOUS: WE ALREADY HAVE A SIMPLIFIED TAX PLAN IN THE TAX CODE. IT IS NOT NECESSARY TO SCRAP THE CURRENT LAW OR CLOSE ALL THE "LOOPHOLES" TO INSTITUTE A SIMPLIFIED FLAT TAX. ALL CONGRESS NEED DO IS PROVIDE AN INCENTIVE FOR ALL TAXPAYERS TO USE THE SIMPLE FEDERAL TAX FORMS THAT ALREADY EXIST.

THE FORMS ARE THE 1040A, KNOWN AS THE "SHORT FORM," AND, FOR THOSE WHO ARE SINGLE AND HAVE NO DEPENDENTS, THE 1040EZ. THE

SHORT FORM IS SO SIMPLE AND UNDERSTANDABLE THAT MILLIONS OF AMERICANS FILL IT OUT EVERY YEAR WITHOUT THE HELP OF AN ACCOUNTANT OR TAX PREPARER. LAST YEAR, MORE THAN 60 PERCENT OF ALL TAXPAYERS USED IT.

WE PROPOSE THAT CONGRESS ADD THE FOLLOWING SENTENCE TO THE TAX CODE: "TAXPAYERS WHO FILE A 1040A OR 1040EZ OR ITS EQUIVALENT WOULD BE REQUIRED TO PAY A MAXIMUM OF 20 PERCENT OF THEIR GROSS INCOME." THIS IS BASED ON THE STATISTICS WE HAVE RECEIVED FROM POLYCONOMICS AND OTHER AUTHORITIES ON THE ECONOMICS OF TAXATION.[1]

THE AVERAGE EFFECTIVE RATE NOW PAID BY THOSE EARNING $50-75,000 A YEAR IN GROSS INCOME IS 18.2 PERCENT. LOWER TAX RATES FOR LOWER INCOME GROUPS UNDER CURRENT LAW WOULD STILL APPLY. THE OPTIONAL FLAT TAX IS A MAXIMUM TAX AND NOT A MINIMUM TAX, SO IT WOULD NOT CAUSE ANY HARM TO THE POOR. BY WAY OF COMPARISON, THIS WOULD ALLOW SOME TAXPAYERS TO OPT FOR AN EQUAL OR HIGHER RATE OF TAXES FOR THE PRIVILEGE OF SIMPLICITY AND DOING AWAY WITH THE WHOLE RECORD KEEPING/AUDIT FUNCTION.

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[1]POLYCONOMICS, INC. Politcal and Economic Communications
Morristown, N.J. 07960

SHEA AND GARDNER Washington, D.C.

## A VOLUNTARY TAX INCREASE

HOWARD J. RUFF, FREE THE EAGLE'S CHAIRMAN, NOTED PUBLISHER, AND FINANCIAL ADVISOR POINTED OUT THAT "THROUGH COMPLEX (AND EXPENSIVE) LEGAL AND FINANCIAL STRATEGIES, THE PURCHASE OF SOME COCKAMAMIE TAX SHELTERS, EXEMPTIONS, DEDUCTIONS, TAX PREFERENCES, TAX CREDITS, AND REAL ESTATE DEPRECIATION, I HAVE MY TAX BILL DOWN BELOW 10 PERCENT. BUT I'D GIVE THAT UP AND PAY 20 PERCENT IF I DIDN'T HAVE TO EXPEND SO MUCH ENERGY AND CAPITAL. I WOULD RUSH TO VOLUNTEER FOR A PERSONAL TAX INCREASE AND I WOULD BE WILLING TO BET THE BUDGET THAT MILLIONS OF HIGH-INCOME AMERICANS WOULD DO EXACTLY THE SAME."

## SPECIAL INTERESTS DERAIL FLAT TAXES

UNFORTUNATELY, THE PRESENT TAX CODE AND MOST OF THE CURRENT TAX PROPOSALS SUFFER FROM AN ACHILLES' HEEL THAT DOOMS THEM. THEY REQUIRE A COMPLETE OVERHAUL OF THE TAX CODE, ELIMINATING MOST OF THE POPULAR TAX BENEFITS, SUCH AS FAVORABLE CAPITAL GAINS TREATMENT AND DEDUCTIONS FOR STATE AND LOCAL TAXES AND CHARITABLE CONTRIBUTIONS. WHENEVER CONGRESS TRIES TO CLOSE A POPULAR LOOPHOLE OR TAX BENEFIT, SPECIAL INTEREST GROUPS FIGHT BACK AND KEEP IT FROM HAPPENING. I THINK YOU KNOW WHAT I AM TALKING ABOUT. AND BECAUSE THESE PROPOSALS WOULD DO AWAY WITH MUCH OF THE EXISTING CODE, THE "ALL OR NOTHING" RESULTS HAVE LEFT US WITH

NO REAL FLAT TAX, WHILE THE SPECIAL INTERESTS GROUPS HAVE SUCCESSFULLY STALLED PROGRESS ON THIS FRONT.

THE OPTIONAL FLAT TAX WOULD FORCE THE PRESENT TAX DEDUCTIONS TO COMPETE WITH A CLEAR AND UNDERSTANDABLE RATE OF TAXATION. IT WOULD PROVIDE A PILOT PROGRAM FOR BROADER USE OF MANDATORY FLAT TAXES LATER. IN THE MEANTIME, WE ARE NOT THROWING OUT THE REST OF THE CODE. THIS IS A MODEST STEP WHICH WILL HELP RESTORE CREDIBILITY TO THE TAX CODE.

THIS PLAN IS ALSO POLITICALLY FEASIBLE. BY BEING OPTIONAL, IT WOULD MERELY SIT ALONGSIDE THE REST OF THE EXISTING CODE. IF INDIVIDUALS FEEL THIS OPTION IS NOT TO THEIR BENEFIT, THEY DO NOT HAVE TO USE IT. THE OPTIONAL FLAT TAX GIVES TAXPAYERS AN OPPORTUNITY TO ABANDON A TAX CODE THAT IS OVERSIZED AND INTIMIDATING.

I.R.S. STATISTICS INDICATE THAT SOME 44 PERCENT OF ALL TAXPAYERS ARE USING PROFESSIONAL PREPARERS. THIS IS UP FROM 37 PERCENT JUST THREE YEARS AGO. ALMOST TWO-THIRDS OF THIS YEAR'S 1040 "LONG FORM" FILERS HIRED PREPARERS WHICH AMOUNTS TO NEARLY A 15 PERCENT INCREASE FROM LAST YEAR.

ABOUT IMPLEMENTING AN OPTIONAL MAXIMUM TAX AT 20 PERCENT ON GROSS INCOME WITH NO DEDUCTIONS, POLYCONOMICS SAYS ". . . CONSIDERABLE ACADEMIC RESEARCH INDICATES THAT THE AMOUNT OF TAXABLE

INCOME WOULD QUICKLY EXPAND, PERMITTING FURTHER RATE REDUCTIONS. WITH THE REDUCTION OF MARGINAL TAX RATES FROM 1981-1983, REVENUES COLLECTED FROM THOSE REPORTING INCOMES ABOVE $150,000 ROSE BY 75.7 PERCENT.

ALTHOUGH A 20 PERCENT MAXIMUM TAX WOULD APPEAR TO REDUCE STATIC REVENUES FROM THOSE REPORTING INCOMES ABOVE $75,000 BY AS MUCH AS $5.76 BILLION (IN 1983)--OR 2.1 PERCENT OF TOTAL INDIVIDUAL TAX REVENUE--THE ACTUAL EFFECT WOULD INSTEAD BE A REPEAT OF THE HUGE REVENUE GAINS OF 1982-83. IT WOULD ALLOW THE TREASURY TO COLLECT SOME OF THE MONEY WHICH NOW GOES FOR COMPLIANCE COSTS."

SEVERAL COUNTRIES OFFER AN ALTERNATIVE "MAXIMUM TAX" THAT LIMITS THE TOTAL TAX AS PERCENTAGE OF GROSS INCOME. THIS ALSO LIMITS A MARGINAL TAX RATE, SINCE THE AVERAGE AND MARGINAL RATES BECOME THE SAME ONCE THE LIMIT IS REACHED. IN HONG KONG, THE TOP MARGINAL TAX RATE IS 25 PERCENT BUT THE MAXIMUM TAX RATE IS 17 PERCENT. IN SWITZERLAND, THE TOP NATIONAL TAX BRACKET IS 13.2 PERCENT, BUT THE MAXIMUM TAX IS 11.5 PERCENT. A SIMILAR CONCEPT IS BEING UTILIZED IN THIS COUNTRY BY THE STATE OF NEW JERSEY.[2]

AN ADDITIONAL ADVANTAGE OF THIS PROVISION IS THAT IT CAN BE ADDED TO ANY TAX BILL NOW BEING CONSIDERED BY THIS COMMITTEE, OR

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[2]POLYCONOMICS

PASSED AS PART OF OTHER LEGISLATION. IF TAX REFORM BOGS DOWN, IT COULD STILL BE ADDED AS A WIDELY POPULAR IMPROVEMENT IN THE CURRENT TAX LAW. EVEN IF THERE IS NO ACTION ON CORPORATE AND BUSINESS TAXES, THIS PROVISION CAN STILL GIVE MILLIONS OF AMERICANS RELIEF FROM A SYSTEM WHICH IS BECOMING SO OVERGROWN AS TO BE IMPASSABLE.

THE OPTIONAL FLAT TAX IS TAILORED FOR INDIVIDUAL TAX RETURN FILERS. MOST TAX REVENUES COLLECTED COME FROM INDIVIDUALS AND NOT CORPORATIONS. ALAN REYNOLDS, VICE-PRESIDENT OF POLYCONOMICS, INC. SAID: "BY FAR THE LARGEST TAX ON CAPITAL, BOTH IN TERMS OF DOLLARS AND MARGINAL RATES, IS THE INDIVIDUAL INCOME TAX. . . "

CORPORATE INCOME TAXES ACCOUNT FOR ONLY 8 PERCENT OF TOTAL REVENUE, AND EFFECTIVE MARGINAL RATES ARE TYPICALLY LOW -- ABOUT 15 PERCENT -- PARTICULARLY ON LEVERAGE INVESTMENTS. IT SEEMS WHILE CORPORATIONS AND SIMILAR INTEREST GROUPS HAVE BEEN MAKING MOST OF THE NOISE, THE INDIVIDUAL TAXPAYER HAS BEEN BEARING MOST OF THE TAX BURDEN. IT MAKES SENSE TO RAISE THE GREATEST PART OF REVENUES IN AS EASY AND EFFICIENT MANNER AS POSSIBLE.

TAXES HAVE DYNAMIC EFFECTS ON THE EFFICIENCY OF OUR ECONOMY. WE DO NOT KNOW OF ANY STATISTICS THAT INDICATE THERE WILL EVER BE A PERFECTLY REVENUE NEUTRAL TAX PROPOSAL AS LONG AS A

MAJORITY OF CONGRESS GIVES IN TO "TAX TAX--SPEND SPEND" POLICIES. MOREOVER, WE BELIEVE THAT BY CUTTING THE MARGINAL RATE TO A MAXIMUM OF 20 PERCENT THE TREASURY WILL ACTUALLY INCREASE TAX REVENUES. IT IS ESTIMATED THAT ON THE COMPARATIVELY SMALL 1981 REDUCTIONS IN MARGINAL TAX RATES CAUSED FEDERAL REVENUES TO RISE BY AN EXTRA 1-4 PERCENT MERELY BECAUSE OF DESIRED SUBSTITUTION OF TAXABLE SALARIES FOR TAX-FREE PERKS.

FREE THE EAGLE BEGAN MENTIONING THIS IDEA IN OUR NEWSLETTER SEVERAL MONTHS AGO. WE RECEIVED A GREATER RESPONSE ON THIS ISSUE THAN ANY OTHER IN SEVERAL YEARS. WE BELIEVE THAT THE TIME HAS COME FOR THIS REFORM. NOT ONLY WILL IT SERVE AS A TRANSITION, IT WILL FINESSE THE OBJECTIONS OF SPECIAL INTERESTS WHO FEED ON THE TAX CODE. NO LOOPHOLE HAS TO BE CLOSED, BECAUSE IT WILL ALLOW THE PUBLIC A CHOICE AS TO HOW THEY WILL PAY THEIR FAIR TAX.

DR. ARTHUR B. LAFFER, A NOTED ECONOMIST BASED IN SOUTHERN CALIFORNIA, SAID THE FOLLOWING IN AN ARTICLE HE WROTE ABOUT THE OPTIONAL FLAT TAX: "THE MOVEMENT TOWARD A SIMPLER TAX SYSTEM WITH LOWER TAX RATES SHOULD NOT BE ALLOWED TO GET BOGGED DOWN IN INTERMINABLE DEBATES OVER THIS DEDUCTION VERSUS THAT SPECIAL INTEREST GROUP. THE DESIRE OF THE AMERICAN PUBLIC FOR A SIMPLER, FAIRER TAX COULDN'T BE CLEARER. IF OUR ELECTED REPRESENTATIVES CAN'T MAKE THE DECISION ABOUT WHETHER OR NOT THE BENEFITS OF A SIMPLER TAX WITH LOWER TAX RATES ARE GREATER THAN THE LOSS OF

THOSE TREASURED DEDUCTIONS, THEN THEY SHOULD LET THE AMERICAN TAXPAYER DECIDE. THOSE WHO INSIST ON KEEPING THE DEDUCTIONS AND COMPLEXITY CAN FACE THE HIGHER TAX RATES. WHILE THOSE WHO PREFER A SIMPLE TAX SYSTEM WITH A LOW TAX RATE CAN ELECT TO FORGO THE DEDUCTIONS."

FREE THE EAGLE IS WORKING ON HAVING THIS LEGISLATION INTRODUCED. WE BELIEVE THAT IT WILL BE AN IDEA WHICH WILL BE POPULAR WITH YOUR CONSTITUENTS FOR THE REASONS WE HAVE MENTIONED.

MILLIONS OF AMERICANS ARE YEARNING TO BREATH THE FREE AIR OF LITTLE OR NO HASSLES FROM THEIR FEDERAL INCOME TAX. FREE THE EAGLE BELIEVES THIS OPTIONAL FLAT TAX WOULD BE A MAJOR STRIDE IN THAT DIRECTION.

THANK YOU.



55-633 O - 86 - 6

Senator SYMMS. Senator Long.

Senator LONG. Mr. Kelso, I discussed the aspects of the Treasury recommendation concerning employee stock ownership with President Reagan; and President Reagan assured me, and the Secretary of the Treasury was there, and he assured Mr. Pearlman, and the Vice President was also there at the time, that he is for employee stock ownership. He doesn't want to do anything to hurt it. Now, I have heard all sorts of expressions of concern that various provisions in this so-called tax reform bill on the House side could be very harmful to employee stock ownership. Would you be willing to tell us which, if any, of those recommendations that are being considered would be the most devastating and most harmful to the employee stock ownership efforts?

Mr. KELSO. I think, Senator, the one that requires the rollout every 84 months is an absolute disaster. It misconceives——

Senator LONG. What do you mean—rollout very 84 months?

Mr. KELSO. That the employee must be able to take down his stock within 84 months. The ESOP is one of the tools designed to bring about full employment American style in the U.S. economy. That means that people who go into the labor market, into the economic order, as labor workers must immediately begin to pick up power as capital workers sufficient so that, by the time they reach retirement age, they can retire from the labor market but stay as capital workers the rest of their lives, being self-supporting. This device is based on the assumption that the object of ESOP legislation is to simply get stock certificates in the hands of the employees so that they can play the stock market game. And every stockbroker in the world will be after them to swap it for some of those low-yield, second-hand securities that are sold on Wall Street.

Senator LONG. Wouldn't that be about the same as if you required a pension plan that after 7 years' accumulation, even among the young workers, you pay the money out so they can spend it if they want to?

Mr. KELSO. Yes, it would. It is even worse because, of course, the ESOP is more powerful than pensions are.

Senator LONG. But basically, as I understand the philosophy of this employee stock ownership movement, we all want the employee to go spend the money and wind up poor—we want him to keep it and get rich.

Mr. KELSO. That is exactly the point to the story. What Congress did in 1984 by making the wages of capital deductible to the corporation like the wages of labor is a wonderful advance. I mean, it was a tremendous thing, but it begins to enable people who have ESOP's—and it would do this for the other seven tools—to first pay for their capital and then get its income. This takes the pressure off the economy from employees' demanding more and more pay for less and less work, which is what happens under our stone age economic policy that says it doesn't make any difference who owns the capital as long as there is plenty of it around. Well, that is what brought us to the disaster we are in. But every one of those provisions in the pending legislation that affect ESOP's is a bad provision. They are as good as they can be at this point; and inasmuch as they are such a teeny bit of the American economy. If you

add up mergers, acquisitions and leverage buyouts, 49 out of every 50 of those is a non-ESOP transaction. Now, that is——

Senator LONG. I would like to ask you some other things. And I will ask you to expand on that and put it in writing so we can put it in the record.

Mr. KELSO. I shall do that. Thank you.

[The prepared information of Mr. Kelso follows:]

**PRESS RELEASE**

LOUIS KELSO WILL TESTIFY BEFORE THE SENATE FINANCE COMMITTEE ON THURSDAY, OCTOBER 10TH, ON "ALTERNATIVE TAX PROPOSALS."

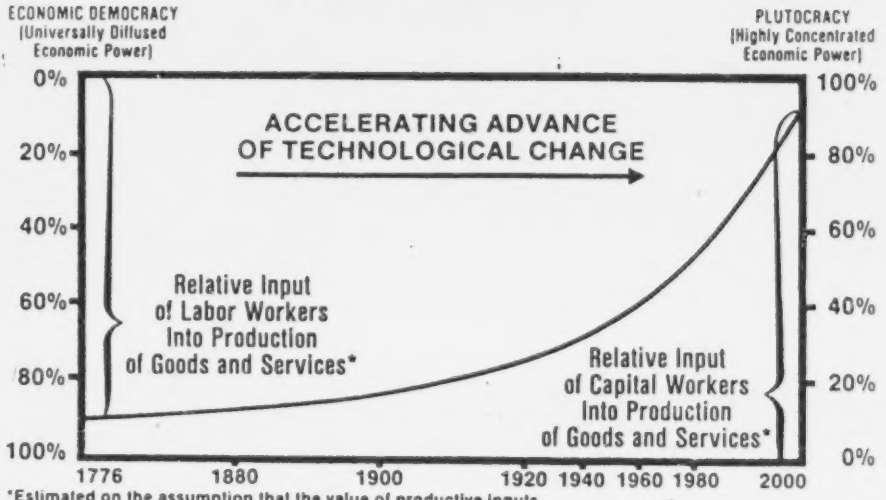
IN ESSENCE, HE WILL SAY THAT THE **ONLY** WAY IN WHICH FEDERAL TAXES CAN BE REDUCED WHILE BRINGING ABOUT BOTH A BALANCED FEDERAL BUDGET AND THE FULL DEGREE OF PROSPERITY THAT THE ECONOMY CAN EASILY PRODUCE, AND THAT PEOPLE BOTH DESIRE AND DESERVE, IS TO CORRECT THE STRATEGIC FACTUAL ERROR IN THE NATIONAL ECONOMIC POLICY.

THAT POLICY, BELATEDLY FORMALIZED IN THE (FULL) EMPLOYMENT ACT OF 1946, IMPOSES ON THE POPULATION THE DUTY TO USE ITS BEST EFFORTS TO ENABLE EVERY FAMILY TO EARN THE INCOME IT WANTS TO SUPPORT ITS LIVING STYLE THROUGH CONVENTIONAL EMPLOYMENT — THE RENDERING OF LABOR OR PERFORMING SERVICES FOR PAY — BY ONE OR MORE OF ITS MEMBERS. TO THE EXTENT THAT DOES NOT SUFFICE, AND ITS ADEQUACY DIMINISHES YEAR BY YEAR, GOVERNMENT MUST PROVIDE WELFARE.

TODAY OVER ONE-HALF OF ALL TAXES, FEDERAL AND STATE, ARE LEVIED ON PEOPLE WHO EARN INCOME, IN ORDER TO TRANSFER THAT INCOME TO PEOPLE WHO NEED MORE INCOME! FURTHERMORE, GOVERNMENTAL REDISTRIBUTION MUST INCREASE FROM YEAR TO YEAR FOR THE SIMPLE REASON THAT THE PACE OF THE TWO-CENTURIES OLD INDUSTRIAL REVOLUTION ACCELERATES AND CHANGES THE WAY THAT GOODS AND SERVICES ARE PRODUCED, BUT IN ONLY ONE DIRECTION: FROM LABOR INTENSIVE TO CAPITAL INTENSIVE.

KELSO USES THIS DIAGRAM TO DRIVE HOME THE POINT:

## CHANGING PARTICIPATION of LABOR WORKERS and CAPITAL WORKERS in PRODUCTION of GOODS and SERVICES




*Estimated on the assumption that the value of productive inputs is measured in reasonably competitive markets.

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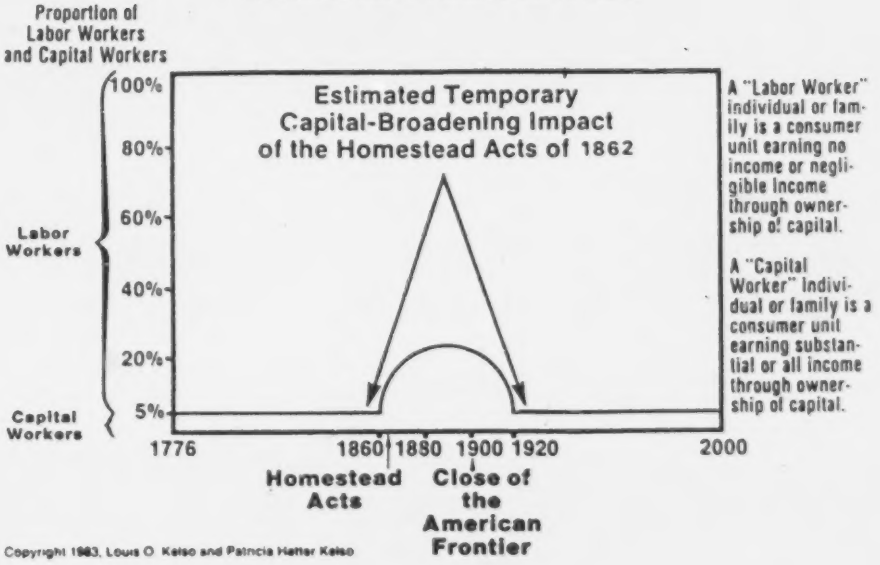
HE CONCEDES THAT THE INFORMATION CONVEYED BY HIS DIAGRAMS ARE ONLY APPROXIMATIONS, FOR THE SIMPLE REASON THAT STATISTICS ARE NOT DESIGNED TO SHOW THE TWO-FACTOR REALITY, BUT ONLY TO REFLECT THE FACTUALLY ERRONEOUS ECONOMIC POLICY: THAT THE ONLY LEGITIMATE WAY TO PARTICIPATE IN PRODUCTION AND EARN INCOME IS TO WORK; TO EMPLOY THE POWERS OF YOUR MIND AND BODY.

KELSO BELIEVES HIS ESTIMATES ARE CONSERVATIVE WHEN HE SAYS THAT WHILE LABOR WORKERS IN COLONIAL TIMES PROVIDED 95% OF THE PRODUCTIVE INPUT, AND CAPITAL WORKERS (PEOPLE WHO ENGAGE IN PRODUCTION AND EARN INCOME THROUGH THEIR PRIVATELY OWNED CAPITAL*) ONLY 5% OF PRODUCTIVE INPUT, TODAY THE RELATIVE INPUTS OF LABOR WORKERS AND CAPITAL WORKERS ARE ALMOST REVERSED: 90% CAPITAL WORKER INPUT AND 10% LABOR WORKER INPUT.

* Normally represented today by Common Stock.

BUT THE TAX AND SOCIAL CATASTROPHIES EMBEDDED IN THIS FACTUAL EVOLUTION OVER THE PERIOD OF THE INDUSTRIAL REVOLUTION APPEAR FROM THE FOLLOWING DIAGRAM:

## THE CONCENTRATION of the OWNERSHIP of CAPITAL OVER the PERIOD of the INDUSTRIAL REVOLUTION


Proportion of Labor Workers and Capital Workers
100%
80%
60%
40%
20%
5%
Labor Workers
Capital Workers
Estimated Temporary Capital-Broadening Impact of the Homestead Acts of 1862
A "Labor Worker" individual or family is a consumer unit earning no income or negligible income through ownership of capital.
A "Capital Worker" individual or family is a consumer unit earning substantial or all income through ownership of capital.
1776
1860
1880
1900
1920
2000
Homestead Acts
Close of the American Frontier

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NOT ONLY ARE CAPITAL WORKERS TODAY A MERE 5% OF THE FAMILIES IN THE U.S., JUST AS THEY WERE IN COLONIAL TIMES, BUT CAPITAL, AS ONE OF THE TWO ALTERNATIVE WAYS FOR PEOPLE TO ENGAGE IN PRODUCTION, IS THOUSANDS OF TIMES MORE POWERFUL THAN IN THE EARLY YEARS OF AMERICAN HISTORY, AND LABOR, IF IT WERE COMPETITIVELY EVALUATED AS OUR COMMITMENT TO THE FREE MARKET ECONOMICS CALLS FOR, IS SUBSTANTIALLY LESS VALUABLE, ADJUSTING FOR INFLATION.

THUS, THE ECONOMY OPERATES, HOWEVER INADEQUATELY FOR MOST PEOPLE, ON REDISTRIBUTION — MOSTLY BY GOVERNMENT TAXATION, AND WHEN THAT IS NOT ENOUGH, BY GOVERNMENT DEBT, PRIVATE DEBT AND BOONDOGGLE-EMPLOYMENT SUBSIDIZED TO GIVE CREDIBILITY TO AN ERRONEOUS ECONOMIC POLICY.

SINCE 1932, MOST OF THE ENERGIES OF CONGRESS AND THE GOVERNMENT'S BUREAUCRACIES HAVE BEEN DEVOTED TO THESE REDISTRIBUTIVE ACTIVITIES.

"AMERICA HAS A RENDEZVOUS WITH DESTINY..." INTONED FRANKLIN D. ROOSEVELT IN 1933. AND SO IT HAS, AGREES KELSO. BUT NOT WITH THE SOCIALIST DESTINY OF REDISTRIBUTING INCOME THROUGH TAXATION AND BOONDOGGLE FROM THOSE WHO EARN IT TO THOSE WHO NEED IT, BUT WITH THE DESTINY OF FULFILLING THE COMMITMENTS OF THE AMERICAN CONSTITUTION TO ENABLE EVERY FAMILY TO EARN ITS OWN LIVING AS THEY DID, BY DESIGN OF NATURE, IN THE PREINDUSTRIAL WORLD.

KELSO, BY READING THE CONSTITUTION IN THE LIGHT OF THERE BEING TWO WAYS FOR PEOPLE TO PARTICIPATE IN PRODUCTION AND EARN INCOME IN AN INDUSTRIAL AGE — EITHER AS LABOR (OR SERVICE) WORKERS, OR AS CAPITAL WORKERS, INTERPRETS THAT WISE DOCUMENT TO MEAN THAT THE FIRST DUTY OF GOVERNMENT TOWARDS CITIZENS, AFTER GIVING THEM PEACE AND PHYSICAL PROTECTION, IS TO ENABLE THEM TO BE ECONOMICALLY AUTONOMOUS, AS GOD MADE THEM IN THE FIRST PLACE. WITHOUT THAT, SAYS KELSO, THERE IS NO RIGHT TO LIFE, OR LIBERTY, OR ECONOMIC HAPPINESS.

— IF INSTITUTIONS CREATED BY GOVERNMENT DESTROY THE VALUE OF A MAN'S LABOR POWER BY ENCOURAGING TECHNOLOGICAL INNOVATION, "DUE PROCESS" DEMANDS INSTITUTIONAL ARRANGMENTS, LIKE THE ESOP AND THE SEVEN OTHER TWO-FACTOR FINANCING STRATEGIES, THAT ENABLE PEOPLE LEGITIMATELY TO BECOME CAPITAL WORKERS.

— IF LEGITIMATE ACCESS TO CAPITAL CREDIT IS THE BEST — PERHAPS THE ONLY — WAY FOR THE 95% OF PEOPLE WITHOUT SIGNIFICANT NON-RESIDENTIAL SAVINGS TO BECOME CAPITAL WORKERS, AND ACCESS TO

CAPITAL CREDIT IS A MATTER OF LAWS, THEN EQUAL PROTECTION OF THE LAWS CONDEMNS PRESENT CONVENTIONAL CAPITAL FINANCING TECHNIQUES AS UNCONSTITUTIONAL; THEY MAKE CAPITAL CREDIT ACCESSIBLE TO THE ALREADY WELL CAPITALIZED RICH, WHO RELATIVELY, AND OFTEN ABSOLUTELY, DO NOT NEED IT, AND DENY IT TO THE UNCAPITALIZED MANY WHO ARE BEING FORCED TO BECOME WARDS OF PUBLIC CHARITY — WELFARE — WITHOUT IT.

KELSO INSISTS THAT HIS OBSERVATIONS ARE NOT IDLE SPECULATION. THIRTY YEARS AGO, HE INVENTED THE EMPLOYEE STOCK OWNERSHIP PLAN OR ESOP, NOT TO RESCUE SICK CORPORATIONS — FOR WHICH MANY "EXPERTS" HAVE USED IT — BUT TO KEEP THE ENTIRE ECONOMY FROM GETTING SICK, AS HE SEES IT TO BE TODAY; TO ENABLE IT TO ENJOY IN PRACTICE THE HIGH PROSPERITY AND PEACE THAT ITS TECHNOLOGICAL ACCOMPLISHMENTS (AND THOSE OF OTHER NATIONS) MAKE PHYSICALLY POSSIBLE.

CONGRESS HAS ALREADY ENACTED SOME 20 LAWS TO IMPROVE THE EFFECTIVENESS AND ATTRACTIVENESS OF THE ESOP. BUT IT STILL MAINTAINS THE NATION'S STONE AGE ECONOMIC POLICY THAT CONDEMNS 95% OF THE FAMILIES TO EARN (OR PRETEND TO EARN) THEIR LIVINGS AS LABOR WORKERS. THAT ECONOMIC POLICY — THE EMPLOYMENT ACT OF 1946 — PROCLAIMS FROM THE SUMMIT OF OUR GOVERNMENT A TERRIBLY MISLEADING FALSEHOOD: THAT THE ONLY WAY LEGITIMATELY TO PARTICIPATE IN PRODUCTION AND TO EARN INCOME IS TO WORK; AND THAT CAPITAL IS A MERE CATALYTIC AGENT: IT MAKES NO DIFFERENCE WHO OWNS IT, SO LONG AS THERE IS PLENTY OF IT AVAILABLE.

THE TRUTH, THE SIMPLE, UNQUESTIONABLE TRUTH, IS THAT, WHILE THERE ARE MANY SAD **EFFECTS** OF POVERTY, THERE IS BUT ONE SIMPLE **CAUSE.**

POEPLE ARE POOR BECAUSE THEY DO NOT OWN SUFFICIENT CAPITAL.

KELSO HAS DEVELOPED SEVEN OTHER CAPITAL FINANCING STRATEGIES BESIDES THE ESOP. EACH INCORPORATES THE LOGIC OF THE ESOP.

THAT LOGIC IS TO ENABLE THE CAPITAL BUYER, NO MATTER WHAT HIS STATION IN LIFE, WHETHER A VIGOROUS AND SKILLED WORKER, OR AN AGED OR INFIRM PERSON, TO BUY PRODUCTIVE, INCOME-EARNING CAPITAL, AND TO PAY FOR THAT CAPITAL OUT OF ITS OWN INCOME, WITH THE FEASIBILITY RISK, THE RISK THAT IT MIGHT NOT MAKE TIMELY AND FULL REPAYMENT, BEING COMMERICALY AND COMPETITIVELY INSURED, LIKE OTHER BUSINESS RISKS.

SINCE THE ONLY ECONOMICALLY LEGITIMATE WAY TO GAIN INCOME IN A FREE MARKET, PRIVATE PROPERTY, DEMOCRATIZED CAPITALISIT ECONOMY, IS TO EARN IT, THE AMERICAN ECONOMIC POLICY SHOULD CALL FOR "LIFETIME EMPLOYMENT - AMERICAN STYLE." MOST PEOPLE WOULD BEGIN THIER LIVES AS LABOR WORKERS; GO THROUGH THEIR MIDDLE YEARS GAINING EARNING POWER AS CAPITAL WORKERS, AND THEN, AT A TIME THAT MAKES SENSE TO THOSE CONCERNED, RETIRE FROM THE LABOR-WORKING WORLD TO LIFETIME CAPITAL WORK.

ARRANGEMENTS LIKE SOCIAL SECURITY AND PENSIONS, AND LIFE INSURANCE (AS DISTINGUISHED FROM PORTFOLIO INSURANCE) MIGHT BE RETAINED AS SAFETY NETS, ONLY TO BE USED IF AND WHEN SOME STRANGE COMBINATION OF FACTS IMPAIRS THE ADEQUACY OF "LIFETIME EMPLOYMENT - AMERICAN STYLE."

Senator LONG. What do you think about the voting rights problem in this matter?

Mr. KELSO. I think that the voting rights are part of stockholders' rights and that employees should have voting rights as soon as it is feasible under the financing concepts that our economy has. Lenders who loan great amounts to enable employees to step up and buy companies without taking anything out of their pockets or paychecks are concerned about the stability and experience of management. Now, stockholders can change the management—a majority can—if they want to. So, normally, lenders simply say there aren't going to be voting rights passed through on that until the loan is paid off; but after that employees should have full voting rights. No question about it.

Senator LONG. Now, you negotiate many of these plans where you borrow the money and use that to buy the stock, and the trustee is holding the stock for the benefit of the workers.

Mr. KELSO. Yes, sir.

Senator LONG. Now, in that situation, as long as the loan is outstanding—let's say 100 percent of it is outstanding—who ought to be voting that stock?

Mr. KELSO. Until the loan is paid, the stock is in effect voted by the committee that is appointed by the board of directors; and that is because the bankers or insurance companies or whomever have faith in that board of directors, and they also want to see that they personally have put in some of their own money. Bankers feel better about that.

Senator LONG. Generally speaking, doesn't it work out that if a bank is going to make a loan to somebody to buy a lot of equipment and build a plant, they want to keep their hand on that money long enough to see that they get their loan paid back?

Mr. KELSO. Absolutely. Elementary.

Senator LONG. And so, that being the case, they usually want that voting power by either stock or the voting power pledged to them long enough to get their loan paid off. Now, if those employees don't know how to vote for things later on, that is their problem after the loan is paid off. But until the loan is paid off, any smart lender is going to want to have enough say to see to it that they don't squander his money away.

Mr. KELSO. Absolutely. And of course it gives us, management and their advisers, 5 or 6 or 7 years to educate employees to understand what it is to be a capital worker. You have to take care of your capital.

Senator LONG. Thank you very much.

Senator SYMMS. Thank you very much, Senator Long. Mr. Kelso, that is an excellent statement and I want to compliment you on the material that you presented to the committee, in addition to what you said. I thank all of you, as a matter of fact, because I find a great deal of sympathy with all three of the witnesses; but I do want to direct a question to you, Mr. Houston. Have you done any estimates? If I understand your proposal correctly, what you are saying is that you would use the current tax law, allow taxpayers to elect to use the short form with a maximum tax rate of 20 percent, and it will be revenue neutral?

Mr. HOUSTON. We hope that it is revenue neutral, but we are not taking any revenue away. We think that the Tax Code is dynamic, though, and the economy would respond to it positively. And so, it would actually raise more revenue.

Senator SYMMS. So, what you are saying is that you can see that after a few years, that you would have down to where maybe only 10 percent of the people are filing the long form, so it would be easier to phase it out?

Mr. HOUSTON. We think people would figure it both ways to begin with.

Senator SYMMS. Man is a rational being, so I would assume that they would pay the lowest number.

Mr. HOUSTON. To begin with, but the thing about tax shelters—take the value of a home as a tax deduction. It wears out as a tax deduction over time. It becomes increasingly unuseful for that purpose. And so, people start to make new tax decisions, and one of them would be to ask: Should I go to the short form? Avoid the audit and the recordkeeping function—or should I buy a bigger house and get a bigger writeoff? We think there is a substantial body of the public which really doesn't want to be in the wheeler-dealer business of tax shelters. Very few people really are very comfortable with that. And this would allow people to opt out of that.

Senator SYMMS. The truth of the matter is that with most tax shelters where people get a bona fide tax deduction out of it, they usually lose the money. That is the part that is always missing. I mean, in most cases, you get involved in one of these things where you get 150 percent tax loss, you usually end up losing the original capital investment.

Mr. HOUSTON. They are very poor investments. That is right.

Senator SYMMS. In other words, your suggestion is to us the current Tax Code and just start allowing a volunteer system to get more people to file the short form and just phase into it without all this big disruption?

Mr. HOUSTON. That is right.

Senator SYMMS. Now, Mr. Warren, you would probably approve of that, wouldn't you? Then you would still have investment tax credits for your plant expansions and so forth.

Mr. WARREN. I would indeed.

Senator SYMMS. In other words, it wouldn't disrupt what you are trying to do?

Mr. WARREN. No.

Senator SYMMS. What is that?

Mr. WARREN. What I am trying to say is only a part of an overall tax program.

Senator SYMMS. What you are really in here saying is that there is a bias in the present Tax Code against savings and that, in order to mitigate the bias against your capital investment, you need investment tax credits. And did you say depreciation?

Mr. WARREN. I am saying a little more than that. I think that the investment tax credit and the ACRS as it has been used has really subverted the intent of the law because so much of that has been used to purchase foreign equipment. It has not created jobs in this country.

Senator SYMMS. All right. I think I get your point. I want to thank all three witnesses. I apologize for recessing the committee now, but if you noticed that everybody left, it wasn't because of the quality of the witnesses. It was because there is a vote on the floor of the Senate right now, and I have just 2½ minutes to get over there and cast mine. Did you want to make one more comment, Mr. Kelso?

Mr. KELSO. Yes, I did. I would like to say that the savings impact of the ESOP and the other seven yet-unused tools on savings is very, very crucial. It creates current savings for people who do not today have savings. Ninety-five percent of all the nonresidential savings in the United States are in the top 5 percent of wealth holders. If you really want to open up the savings valve, do it by changing the economic policy, which can be done by just reinterpreting the words—I don't think it even takes a law—and beginning to implement a two-factor policy in which we say that the use of capital to earn income shouldn't be limited to an elite. It should be available to everyone. Then, you make everyone a saver.

Senator SYMMS. In other words, expand the acceptance of capitalism to more and more people.

Mr. KELSO. That is exactly right.

Senator SYMMS. It would make for a much more rational Government.

Mr. KELSO. Democratize it. Democratize economic power. Social power is composed of political power and economic power. Our Founding Fathers introduced political democracy into a preexisting economic democracy, but the industrial revolution just changed the way goods and services are produced. So, we are no longer an economic democracy and that is dangerous.

Senator SYMMS. All right. I thank all the witnesses very much. This panel is dismissed; and I would ask Dr. David Bradford, Dr. John Makin, and Dr. Norman Ornstein to get prepared to get up to the table. And as soon as Senator Grassley returns, we will commence the hearing. I apologize, but I have to go.

[Whereupon, at 11:30 a.m., the hearing was recessed.]

AFTER RECESS

Senator GRASSLEY. If I could have the attention of everybody, it is the desire of Senator Symms that I proceed with the next panel, panel IV, consisting of Dr. David Bradford, professor of economics and public affairs and associate dean, Woodrow Wilson School, Princeton University; Dr. John Makin, director of fiscal policy studies, the AEI; and Dr. Normal Ornstein, resident scholar of the AEI here in Washington, DC. I would ask that you proceed in the manner in which you are on the agenda. So, it would be Dr. Bradford, if you are prepared to go ahead.

## STATEMENT OF DR. DAVID F. BRADFORD, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, AND ASSOCIATE DEAN, WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY, PRINCETON, NJ

Dr. BRADFORD. Mr. Chairman, thank you very much for the invitation to discuss with you today an alternative approach to income

tax reform. There are two ways to fix the income tax, individual and corporate. One is to pursue a painstaking provision-by-provision reform. This is the approach taken in the President's May 1985 proposal, which is now undergoing testing in the Ways and Means Committee. The outcome may be a substantial change in the income tax; but at best, it will leave a system with many serious problems. What are some of the problems? I would mention four. First, the system will not be simple. Second, the real effects of the system will continue to be sensitive to the rate of inflation. Third, the system will continue to tax very differently the returns received by savers and investors on different forms of saving and investment. And fourth, the system will continue to impose separate taxes on corporations and individuals.

The alternative approach I have in mind is directed at the following objectives. It should have the simplification advantages of a VAT. It should be implementable as an add-on to the existing tax, and in that sense, not be a new tax. It should be implementable on a small scale, that is, like a VAT it should be possible to institute the plan at a low rate. And unlike a VAT, it should have the potential to replace the existing income tax entirely on a phased-in basis.

I call my proposed answer to these four objectives the *x* tax. The *x* tax is based on a scheme developed by Robert Hall and Alvin Rabushka of Stanford University, which has been introduced as a bill by Senator DeConcini. The proposal differs from theirs in its system of rates and in the suggested transition. I describe the approach—I shall describe it now—as though it were going to be a total replacement for the income tax; and then I will come back and explain how one might use the same idea instead, either as a way simply to supplement the tax or as a way that one could use it as a phased reform which would ultimately replace the income tax.

So, let me start by describing how it would work if we just scrapped the income tax and used the *x* tax. It consists of an integrated two-component system. One component is the compensation tax, and the other is the business tax. The compensation tax is paid by individuals and families on the basis of wages, salaries, and pensions received. The amount of compensation in excess of personal allowances, is subject to tax at graduated rates. For example, the rates of 15, 15, and 35 percent at higher and higher brackets found in the President's proposal might be used. In essence, the business tax is the same as the BTT. It would be filed by all businesses, whether corporations, partnerships, or proprietorships. The base of the business tax would consist of the proceeds of sales less the sum of purchases from other firms and amounts paid to employees as wages, salaries, or pensions. The business tax would ignore financial transactions such as borrowing, payment of dividends or interest. The rate applied to the business tax would be the same as the top rate on the compensation tax.

The *x* tax is economically similar to a value-added tax combined with a graduated wage subsidy. The economics of it is much the same. It offers, however, significant advantages over a value-added tax. First, it deals directly and simply with the regressivity problem that plagues a value-added tax by providing the graduation in the compensation tax component. Second, because its quality of

being an income tax is quite appropriately stressed, it is less vulnerable to the tendency to erode the base for exemption of favored commodities. Third, by splitting off the compensation portion of the base to be taxed at the employee level, the tax system remains visible to everyone, which I regard as an advantage.

The *x* tax really is simple. The system also solves other problems that have proven intractable under the existing income tax. In particular, tax burdens under the *x* tax are not influenced by inflation. The system automatically integrates individual and business, including corporate, taxes. The *x* tax is uniform across assets and industries and therefore causes much less distortion of business decisions of all kinds than does the present system. The *x* tax provides a convenient mechanism for taxing employee fringe benefits, assuming one wants to do so. A fairly simple way is even available under the *x* tax to allow retention of the mortgage interest deduction, even though normally interest is neither deducted nor included under the *x* tax.

That is a rough outline of the tax as a replacement of the income tax, but it is such a simple tax and on such a broad base that it could also be employed easily as an add-on to either the existing or to a reformed income tax to raise additional revenue. For example, if an *x* tax with a structure of rates and exemptions running from 15 to 35 percent is determined to be sufficient to cover existing income tax revenues, then the equivalent of a 10-percent increase in income tax receipts would be obtainable by an add-on *x* tax with the same exemptions and with rates of 1.5, 2.5, and 3.5 percent—in other words, quite low rates. The information required for the *x* tax is already needed to calculate the existing income tax base. It would require an additional line or two on form 1065 and on schedule C or F of form 1040, but it would be very, very simple.

Now, let me just briefly summarize how one could use the same technique as a phased replacement entirely of the income tax. The basic technique would be to start with an add-on tax, for example at 20 percent of the level that is determined to be sufficient to replace the income tax. In my illustrative case, the rates would be 3, 5, and 7 percent on the higher and higher brackets. That could then be combined with an instruction to taxpayers to pay only 80 percent of the bottom line on their income tax return. You pay the *x* tax at graduated rates of 3, 5, and 7 percent; then go to the last line of your income tax return and pay only 80 percent of that. If it is a rebate, you only get 80 percent of the rebate.

The immediate result of this would be a small tax reduction for many people and lower marginal rates of income tax and *x* tax combined on key activities. As for complete tax reform, in the future one could simply do more of the same. In stage II, take 40 percent of the *x* tax and pay only 60 percent of the existing income tax. In stage III, 69 percent of the *x* tax and 40 percent of the existing income tax, and so on. One could also stop at an intermediate phase and thereby obtain some advantage of reducing the importance of the income tax with all of its defects. There would still be a gain, I believe, if one did that. But the ultimate objective of replacing it completely would certainly be what I would argue for.

Senator GRASSLEY. Thank you, Dr. Bradford.

Dr. Makin.

[The prepared written statement of Dr. Bradford follows:]

STATEMENT

OF

David F. Bradford

Professor of Economics and Public Affairs and Associate Dean of the
Woodrow Wilson School, Princeton University
Tax Program Director, National Bureau of Economic Research

on

Income Tax Reform

before

FINANCE COMMITTEE

U.S. SENATE

October 10, 1985

Senate Finance Committee
Washington, D.C., October 10, 1985

Statement of David F. Bradford

Professor of Economics and Public Affairs and Associate Dean of the Woodrow Wilson School, Princeton University
Tax Program Director, National Bureau of Economic Research

Mr Chairman and members of this distinguished committee, thank you for the invitation to discuss with you today an alternative approach to income tax reform. It would obviously be easy to write a book on a subject so vast, and I have.* However, in the few minutes at my disposal I shall try to explain briefly why an alternative approach is needed and to provide a sketch of a system that seems to me to have considerable merit.

Income tax reform is on the agenda because of the widespread belief that the system has become too complicated, that the rates are too high, and that the various provisions give rise to an unfair distribution of the tax burden. The tax system is seen as interfering too much with day-to-day economic decisions, and permitting too many

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*Untangling the Income Tax, to be published by Harvard University Press as a Committee for Economic Development supplementary paper. The views expressed in this statement are entirely my own and do not represent the position of Princeton University, the National Bureau of Economic Research, or the Committee for Economic Development.

taxpayers to send too few dollars to the Treasury. Each of these points may be arguable, but I propose today to accept as given that the income tax system, in both its individual and corporate parts, needs to be repaired.

## The Traditional Reform Approaches

There are, broadly speaking, two ways to fix the income tax. One is to pursue a painstaking provision-by-provision reform. This can be taken either as a long-term, incremental enterprise or as a once-and-for-all fix. Many observers would say the long-term, incremental strategy is what got us into the present situation. (I would argue many of the shortcomings of the existing system derive from pursuit of the wrong target.) The once-and-for-all fix is the approach suggested by the Treasury in its proposal of last November, as well as the approach taken in the President's May 1985 proposal which is now undergoing testing in the Ways and Means Committee. The outcome may be a substantial change in the income tax, but I think at best it will leave a system with many serious problems.

What are some of the problems? I would mention four. First, the system will not be simple. One can quarrel about what simplicity means, but it is clear that for many taxpayers, including most business taxpayers, the income tax system that will emerge as a result of the Administration's initiative will be at least as complicated as the one we have now. Many people believe that there is an unavoidable trade-off

between simplicity and fairness. They think that tax complexity, both in terms of the rules themselves (who can read them now?) and in terms of the tax planning problems confronting taxpayers, is a necessary price for progressivity. I do not agree.

Second, the real effects of the system will continue to be sensitive to the rate of inflation. Even if the indexing provisions foreseen for depreciation and capital gains are retained in the legislation (and it seems unlikely that they will), there will be serious distortions due to failure to correct the measurement of interest payments and receipts for the inflation element they contain. This phenomenon has a corrosive effect on the income tax system that is all too little appreciated.

Third, the system will continue to tax very differently the returns received by savers and investors on different forms of saving and investment. A well-known instance is the difference between the tax treatments of interest received and capital gains, but there are many others. Whatever one may think about the capital gains provisions, there is no denying the mischief that is created when economically similar transactions are taxed very differently. The formulation of special rules in an attempt to make legal distinctions where economic distinctions are virtually nonexistent (as in the difference between a capital gain and other types of yield from investing) is a major reason that the tax law is so complicated. Inconsistencies in the taxation of saving and investment transactions also deserve much of the blame for

the regrettable presence in the current law, and in the President's reform proposal, of ad hoc patches such as the minimum tax provisions (the function of which is largely cosmetic), limits on the deductibility of interest, and the surtax on distributions from tax-favored retirement plans that are in excess of "reasonable levels."

Fourth, notwithstanding a possible gesture toward integration represented by the partial deductibility of dividends paid from the base of the corporation income tax, the system will continue to embody an uneasy amalgam of taxes on corporations and individuals. It is not that taxes levied on corporations are necessarily a bad idea, but that the existing system is so unpredictable in its incidence and so distorting in its economic effects.

## An Alternative Approach

I observed there are two ways to fix the income tax. The first way, which I have just reviewed, involves a painful, head-on confrontation with the many peculiar features of the existing system, involving wrenching political and economic dislocations. A second approach is to turn to another system, one which could be used in the short run to reduce the importance of the existing income tax and could in the long run replace the existing system altogether.

It is common to assume that the new revenue instrument will have to be a VAT. The VAT, however, suffers from regressivity, which would inevitably be countered by extremely complex provisions exempting

necessities from the base, and from a host of other administrative problems. The VAT certainly could not be used to replace the income tax entirely, in the short or the long run.

The alternative approach I have in mind is directed at the following objectives:

- o It should have the simplification advantages of a VAT.
- o It should be implementable as an add-on to the existing tax (and in that sense not be a new tax).
- o It should be implementable on a small scale -- that is, like a VAT it should be possible to institute the plan at a low level as a permanent feature of the tax system, using the revenues to finance either deficit reduction or reduced reliance on the the existing income tax rules.
- o Unlike a VAT, it should have the potential to replace the existing income tax entirely, on a phased-in basis.

Hoping to have picked a neutral name, I call the proposed system the X-Tax. The X-tax is based on the scheme developed by Robert Hall and Alvin Rabushka of Stanford University, which has been introduced as a bill by Senator DeConcini. The proposal differs from theirs in the system of rates and in the suggested transition. I shall describe the approach first as a total replacement for the existing income tax on individuals and corporations (which is how I think of it), then explain how it could be used as an add-on to provide additional revenue, or

phased in to replace the existing income tax in whole or in part. Obviously, I can provide only the barest sketch, which will leave many questions unanswered.

The X-Tax as a Replacement for the Income Tax

The X-tax consists of an integrated two-component system. One component is the compensation tax, and the other is the business tax. The compensation tax is paid by individuals and families on the basis of wages, salaries and pensions received. The amount of compensation in excess of personal allowances is subject to tax at graduated rates. For example, the rates of 15, 25 and 35 percent found in the President's proposal might apply. (I have not attempted to work out specific rates or brackets, which would depend in part on the extent of spending programs adopted to replace existing tax provisions.)

A business tax return would be filed by all businesses, whether corporations, partnerships or proprietorships. The business tax would be a convenient mechanism for collecting at source income that would otherwise be taxable to individuals. The base of the business tax would consist of the proceeds of sales less the sum of purchases and amounts paid employees as wages, salaries or pensions (or deposited in pension plans for future payment to employees). The business tax would ignore financial transactions, such as borrowing, payment of dividends, etc. The rate applied would be the top individual rate.

The X tax is economically similar to a value-added tax of the consumption type ("consumption type" because business outlays for

capital purposes are expensed immediately, rather than capitalized and depreciated), combined with a graduated wage subsidy. It offers, however, significant advantages over a value-added tax. First, it deals directly and simply with the regressivity problem, by providing the graduation in the compensation tax component. Second, because its quality of being an income tax is, quite appropriately, stressed, it is less vulnerable to erosion through exemption of favored commodities -- no one ever seems to advocate that grocers be allowed to omit their receipts from sales of food from the calculation of income subject to tax, or that roofing companies not include payments from universities or local governments. (Such transactions are often excluded from value-added or retail-sales taxes.) Third, by splitting off the compensation portion of the base to be taxed at the employee level the tax system remains visible to everyone, whereas a value-added tax is normally paid (not, of course, borne) by businesses alone. At the same time, such complexity as remains is only at the firm level.

The X-tax really is simple. Two main features account for the simplicity. First, all the calculations are made on a cash flow basis. Allowable deductions occur when money is paid to a supplier; required inclusion in the tax base occurs only when money is received from an employer (in the case of the compensation tax) or customer (in the case of the business tax). Outlays for business equipment are simply deducted when made; conversely, the proceeds of sale of an asset are simply included immediately in the tax base. Complicated provisions for

calculating depreciation, special rules for installment sales, intricate rules for keeping track of inventories -- these and many other difficult problems in the existing tax system fall away. Second, most financial transactions removed from the tax base altogether. Of particular importance is the fact that interest is neither deductible by the person or business that pays it, nor includable by the person or business receiving it. In a sense, the interest is pre-taxed. In a similar way, dividends and capital gains arising from earnings at the business level need not be taxed to the individual, because they have been, in effect, already taxed.

Together these two features of the tax calculation result in a very simple system. The system also solves other problems that have proven intractable under the existing tax. In particular, tax burdens under the X-tax are not influenced by inflation (basically because interest is neither deducted nor included and because all outlays and receipts are taxed in the same year they occur). The system automatically integrates individual and business (including corporate) taxes. The X-tax is uniform across assets and industries, and therefore causes much less distortion of business decisions of all kinds than the present income tax does. The X-tax provides a convenient mechanism for taxing employee fringe benefits (assuming one wants to do so; the key operating principle is "no inclusion, no deduction;" whatever is deducted by a business must be on the inclusion side of either another business or of an employee). A fairly simple way is even available to

allow retention of the mortgage interest deduction. (In essence, keep the current treatment: Make the recipient of interest that has been deducted include the amount in his tax base. Normally, under the X-tax interest is neither deducted nor included.)

Because capital outlays by businesses are immediately deducted, rather than depreciated over a period of years, the economic effect of the X-tax is to base tax burdens on the consumption levels of individuals. I find this a positive characteristic of the tax, but many tax experts feel differently. Rather than have the best be the enemy of the good, it seems sensible to have available a way to permit compromise on the income vs. consumption dimension. In the existing tax this is very difficult to do without making a mess, basically because of the treatment of interest. But the X-tax structure could be readily converted to an income base, or anything between an income and a consumption base to a degree to be determined by the outcome of the policy argument. To be sure, there would be some cost in increased complexity. But it could be done without sacrificing most of the simplification advantages of the X-tax. All that would be required would be to replace expensing of outlays for equipment, structures, inventory, etc., by a system of capital recovery allowances. It would be desirable and possible to make those allowances insensitive to inflation (by, for example, indexing them).

The flat rate of business taxation together with the noninclusion-nondeduction of interest gives this system the great advantage that it

would be easy to make the degree to which it is on an income versus a consumption basis a simple matter of policy. The trick would be to permit immediate expensing of whatever fraction of investment is desired, with depreciation of the remaining basis. By making the expensed fraction 1, the tax can be put on a consumption basis. By making it 0, the tax is put on the traditional income basis. (Because interest is neither deducted nor included, problems of portfolio bias would not arise.) People will differ in their views about what would be desirable values for the various parameters of Plan X. Some will want a more or a less progressive compensation tax. Some will want the expensed fraction equal to 0; others will want it equal to 1. It is probable that, if the basic approach began to be taken seriously, most policy makers would come to favor the consumption approach (for the same reason the consumption-type VAT seems more common than the income-type).

Use of the X-Tax for Additional Revenue

The X-tax is so simple, and on such a broad base, that it could easily be employed as an add-on to either the existing or a reformed income tax to raise additional revenue. For example, if an X-tax with a structure of rates and exemptions running from 15 to 35 percent is determined to be sufficient to cover existing income tax revenues, the equivalent of a 10 percent increase in income tax receipts would be obtainable by an add-on X-tax with the same exemptions and rates of 1.5, 2.5, and 3.5 percent.

The information required for the X-tax is already needed to calculate the existing income tax base. It would not be entirely free, as it would require an additional line or two on Form 1065 and on Schedule C or F of Form 1040. But these small additions would be insignificant when compared with, say, calculating indexed depreciation under CCRS, let alone with the existing minimum tax. The important principle is that the tax calculation for the X-tax would be entirely separate from the regular tax.

Phased Replacement of the Income Tax

In my view, a phased introduction of the X-tax would provide an attractive alternative to the present path of income tax reform. It would involve exactly the same basic implementation steps as described above for additional revenue, but it would be combined with reduction in the existing income tax, not through changes in the rates or narrowing the base, but through a simple proportional change in the bottom line. For example, the add-on introduction of the X-tax at 20 percent of the level determined to be sufficient to replace the income tax -- on my illustrative assumptions at rates of 3, 5, and 7 percent -- could be combined with an instruction to taxpayers to pay the sum of the add-on tax and 80 percent of the existing income tax, warts and all. The immediate result would be small tax reductions for many people, and lower marginal rates (of income tax and X-tax combined) on key activities (ordinary employment, ordinary business investment, ordinary saving at interest, etc.)

As for complete tax reform, in the future one could simply do more of the same. In stage 2, take 40 percent of the X-tax result and pay only 60 percent of the existing income tax; in stage 3, 60 percent of the X-tax and 40 percent of the existing income tax, and so on. One could also stop at an intermediate phase. Even though it would mean forgoing the significant advantage of scrapping the whole complicated present system, there would still be a gain from reducing its importance.

## Conclusion

The proposed direction of change now under way may produce an improvement over the existing system. But it is far from the real simplification and rationalization that is within reach. We may be about to miss an opportunity for a genuine transformation of the tax system. The approach I have suggested presents an alternative path we could follow now toward a system that everyone could understand and trust, and that would hold to a minimum the distorting effects of taxes in our economic lives.

**STATEMENT OF DR. JOHN H. MAKIN, DIRECTOR OF FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC**

Dr. MAKIN. Thank you, Mr. Chairman. We are pleased to testify before this distinguished committee on our alternative tax plan. We believe that the American tax system does need overhaul. We also believe that collaboration between an economist and a political scientist might help to shape a sound alternative to the current system that Congress can realistically consider adopting. The core of our plan is balanced base broadening, that during its initial 5-year phase-in permits a reduction of the top tax rate for households and corporations to 30 percent.

While we support the thrust of the President's plan, it is in our view hampered by selective base broadening. The burden of base broadening necessary to provide the revenue to enable a lowering of tax rates in any tax reform plan is unevenly distributed under the President's plan. Total rescission of deductibility of State and local taxes for households, together with rescission of investment tax credits and recapture provisions for corporations result in an uneven distribution of the inevitable costs of transition to a new system. The President's plan has, in our view, two other serious flaws. First, indexing for inflation to assure that the level and distribution of tax burdens is not capriciously altered by inflation is inadequate and applied unevenly. I might add that, as the bill has progressed, its inflation indexing features have deteriorated. There seems to be a built-in problem where you try to treat capital income properly with indexing provisions. As those provisions move through the various committees, they tend to be eliminated. The second problem with the President's plan is that the phase-in rules are uneven. Some new provisions would be effective almost immediately, while others such as the desirable indexing of basis for capital gains would not take effect until 1991. No plan is perfect, and we do not claim perfection for ours; neither do we claim great originality. We have tried to combine the best features of the President's plan with the best features of plans offered by Members of Congress. Elements of the Bradley-Gephardt, Chafee-Stark, Kemp-Kasten plans are clearly evident in our plan. So, too, is Senator Packwood's call for the lowest possible top rate in a system that is fair, while providing ample incentive for growth.

Let me begin to sketch some of the features of the plan briefly, and then Norm Ornstein will carry on. tax rates: A triad of rates, 15, 23, 30 for individuals, and 30 percent for corporations. Base broadening: cut in half the value of all tax expenditures. All deductions, exemptions, and exclusions currently identified as tax expenditures by the Joint Committee on Taxation would be converted to tax credits equal to their current value to those in the 15-percent tax bracket. For example, a $2,000 exemption would become a $300 tax credit; $10 million of accelerated depreciation would become a $1.5 million tax credit, with straight line depreciation and other normal costs of doing business remaining fully deductible. ITC goes from 10.6 to 5.3; no recapture is required. And Professor Bradford has eluded to this as well: Our plan would be fully indexed for inflation. All provisions expressed as dollar amounts,

such as the personal exemption for households or cost basis for capital gains or depreciation in inventory calculations for business, would be indexed. This is essential. If you are going to stick with an income tax system, you have got to treat income from capital in a predictable way. Otherwise, you essentially run into the kinds of problems that we were trying to address in 1981 with ITC and ACRS. I think another thing that I want to emphasize is that this would encourage a stable and predictable Tax Code. First of all, lower tax rates, which are part of our plan, sharply cut incentives to seek tax breaks, thereby reducing the pressure on Congress for constant tinkering with the Tax Code. You are talking 30 cents on the dollar instead of 50 cents on the dollar; the pressure for tax breaks is less; tax expenditures are less; but the base broadening is easier. Inflation indexing protects the level and distribution of tax incentives from the capricious and unpredictable effects of inflation.

Indexing provisions such as indexing basis for calculating capital gains or the depreciation allowance, together with the corporate tax rate of 30 percent and a top individual rate of 30 percent, would eliminate the need for special treatment of capital gains. And of course, the special tax treatment of capital gains creates at least the problem of perceived unfairness. And again, when we are building in exclusions on capital gains, essentially we are trying to avoid the taxation of illusory capital gains. So, if you index basis and have a low rate, you essentially solve the problem in advance. International competitiveness: A major difference between the United States and Japanese Tax Codes, notwithstanding a good deal of comment about the major differences, is really the stability and predictability of major provisions and the level of tax expenditures, not the level of tax burdens.

The Japanese Tax Code essentially doesn't change. It changes very little; and as I have mentioned in testimony to this committee previously, the level of tax expenditures is tiny—$1.5 billion for corporations—relative to the $95 billion that is in our code. Our plan by indexing for inflation and lowering rates provides for a stable Tax Code with revenue gain from phasing down on even unpredictable tax expenditures. And I will just point out that there are some tables appended to our testimony which show that if you look at tax expenditures as a whole in their major categories, their ratio to GNP, that is their real value, is highly volatile, highly sensitive to inflation. So, we essentially have designed a Tax Code that is prospectively very uncertain. This is one of the things we are trying to get at. Let me stop here and let Norman Ornstein continue.

Senator GRASSLEY. Dr. Ornstein.

[The prepared written statements of Dr. Makin and Dr. Norman L. Ornstein follow:]

Statement of
John H. Makin and Norman Ornstein
of the
American Enterprise Institute

before the
Senate Finance Committee
Congress of the United States

October 10, 1985

This statement is not available
for public release until it is
delivered at 9:30 a.m. (EDT)
on Thursday, October 10, 1985.

Testimony

John H. Makin and Norman Ornstein

Mr. Chairman, we are pleased to testify before this Committee on our alternative tax plan. We believe that the American tax system needs overhaul. We also believe that collaboration between an economist and a political scientist can help to shape a sound alternative to the current system that Congress can realistically consider adopting.

The core of our plan is balanced base broadening that during its initial 5 year phase-in permits a reduction of the top tax rate for households and corporations to 30 percent. While we support the thrust of the President's plan, it is, in our view, hampered by selective base broadening. The burden of base broadening necessary to provide the revenue to enable a lowering of tax rates is unevenly distributed. Total rescission of deductibility of state and local taxes for households, together with rescission of investment tax credits and recapture provisions for corporations, result in an uneven distribution of inevitable costs of transition to a new system.

The President's plan has two other serious flaws. First, indexing for inflation to assure that the level and distribution of tax burdens is not capriciously altered by inflation is inadequate and applied unevenly. Second, phase-in rules are uneven: some new provisions would be effective almost immediately while others, such as desirable indexing of basis for capital gains, would not take effect until 1991.

No plan is perfect and we do not claim perfection for ours. Neither do we claim great originality. We have tried to combine the best features of the President's plan with the best features of plans offered by members of Congress. Elements of the Bradley-Gephardt, Chafee-Stark and Kemp-Kasten plans are clearly evident in our plan. So, too, is Senator Packwood's call for the lowest possible top rate in a system that is fair while providing ample incentive for growth.

The similarity among key elements of major tax reform plans is not surprising. Tax reform aims at enabling taxpayers to keep more of every dollar they earn irrespective of how they earn it. To do so requires sharply lowering tax rates, which means that in order to preserve revenue neutrality more things must be taxed. Taxing more things, base broadening, entails phasing back the $365 billion in revenue lost during 1985 on tax expenditures.

This process is not intended to suggest that many such tax expenditures are not aimed at worthwhile objectives. Rather, it recognizes that since 1974 tax expenditures have nearly doubled as a share of GNP. (See Table 1.) Further, it advances the more controversial notion that many of those objectives would be better achieved by leaving more of additional earnings in taxpayers' hands after they pay their taxes without regard to whether the additional dollars were earned by investing in high tech instead of real estate or by spending more hours at work in one's chosen profession instead of spending more hours at work with one's accountant.

By moving in steps over five years to a stage where a dollar of tax incentives is worth the same to all taxpayers, we remedy a fundamental problem of fairness in the current system. Tax

expenditures, and by this term we mean everything from deductibility of state and local taxes to the standard exemption and the ITC, are regressive. They place more of the burden of taxation on those of low and moderate income. Perhaps the clearest example is the $2000 exemption proposed by the President as "fairness to the poor." That exemption cuts taxable income for everyone by $2000. For those in the top tax bracket it's worth 50 cents on the dollar or $1000. For those in the lowest bracket it's worth 14 cents on the dollar or $280, just 20 percent as much. Would anyone intentionally announce "a tax break for the poor" that benefits the rich nearly 4 times as much as it does the poor?

We propose a simple remedy to this and other cases of regressive tax breaks. Convert the tax break into a credit at the lowest tax rate and give everyone the same credit. If the lowest rate is 15 percent, as in the President's plan, a $2000 exemption becomes a tax credit of $300. Every taxpayer gets $300 off his tax bill. The high-income taxpayer, instead of saving $1000 in taxes as under the current plan, gets $300 off his tax bill just as the lower-income taxpayer does. Converting the $2000 exemption in the President's plan to a tax credit of $300 would raise at least $20 billion annually and, by raising the most from top-bracket taxpayers, would distribute more fairly the benefits of rate reductions. This change, together with indexation of basis for calculating capital gains taxed as ordinary income at a rate close to 30 percent, would eliminate the need for a fourth bracket.

Much of this is already in the Bradley-Gephardt proposal. We would go further in two ways. First, all provisions would be indexed.

This provision is important for both fairness and investment incentives. It makes no sense to give a $300 tax credit if its value depreciates at a capricious rate governed by the path of inflation. Likewise, it makes no sense to tax investors even at a 30 or 35 percent rate on illusory inflation gains. How many investors have sold stocks after a holding period which saw their dollar value double, only to realize that prices of everything else doubled as well and that taxes are due on a zero or negative real gain? The capital gains exclusion, like the investment tax credit and accelerated cost recovery system, is a crude ex post attempt to deal with the inflation problem. These methods are economically and politically inferior to indexing. Economically their value is uncertain since they depend on inflation and the inclination of a fickle Congress to alter them. Politically they seem unfair since they single out for special treatment a form of income concentrated among the rich and corporations.

Our proposal differs from Bradley-Gephardt especially in the area of investment. Besides indexing basis for capital gains, we would adhere to a balanced phase-down of all tax preferences to about half current levels in exchange for a 15-23-30 triad of rates. The investment tax credit would be phased down from 6/10 levels to 3/5. ACRS benefits would, like all others, be converted to tax credits at a 15 percent rate. For example, if a corporation had depreciation in excess of straight line depreciation, which along with costs of labor and material would remain fully deductible along with all normal costs of doing business, worth $10 million, it would receive a tax credit of $1.5 million. The basis for calculating depreciation and FIFO inventory changes would be indexed for inflation.

Another important effect on investment and growth of indexing and phase-down of existing incentives to finance a cut to 30 percent in the corporate rate would be a leveling of tax burdens across alternative forms of investment. Under current law some investments enjoy negative tax rates while others are taxed at close to statutory rates. This is evident from a look at the distribution of tax burdens across industries and alternative forms of investment. Studies by AEI economists and others suggest that gains in the vicinity of a permanent 1 percent increase in GNP are realizable from a leveling of tax burdens across alternative forms of investment.

Part of the problem arises from constant tinkering with unindexed tax breaks designed to help compensate for inflation which along with changing political attitudes make ACRS, ITC, capital gains, and other provisions subject to huge swings. (See Tables 4-7.) The same is true for major household provisions. (See Tables 2 and 3.) By scaling down and indexing those provisions, our plan makes their impact more even and more predictable while at the same time enabling lower tax rates that serve as the strongest incentive for capital formation and growth. The knowledge that more effort will bring in additional income, at least 70 cents on the dollar of which will be kept after taxes irrespective of inflation or how it is earned, allows households and corporations to make financial decisions based on their economic merit instead of their tax consequences.

As with any fundamental change, this system would impose burdens on heavy users of tax preferences. The costs of a transition to a new system could be reduced by gradually phasing in the system over a period of years. One route would be to begin by capping deductibility

at 35 cents on the dollar in 1986 and moving down in increments of 5 percentage points per year to 15 cents on the dollar in 1990. Marginal rates over that period could also be continually adjusted to maintain revenue neutrality. This is not an "all or nothing" plan. Congress can select the degree and pace of reform. The President's insistence that tax reform be "revenue neutral" and Congress's nervousness about deficits can be accommodated by phasing in lower rates gradually while accelerating base broadening. Thus, the plan could raise revenues in the first couple of years to reduce deficits but give more tax breaks later to make the plan revenue neutral over five years.

This plan is obviously not a pure as the total elimination of all exemptions and preferences. Such a step is simply politically impossible during the initial phase of tax reform. In the real world, the concept of base broadening that touches everyone equally seems the best way to achieve the goal of lower tax rates and, in broader terms, a tax system consistent with fairness, growth, and simplicity.

Makin-Ornstein
Attachments

(1) New York Times description of the plan.

(2) Tables 1-7: the growth and instability of tax expenditures.

New York Times, August 26, 1985

# A Simple, Balanced Plan for Tax Reform

By John H. Makin
and Norman J. Ornstein

WASHINGTON

PRESIDENT Reagan's tax reform plan is under attack on all fronts. Some critics complain that it penalizes the average middle-class family while allowing the super-wealthy to benefit. Meanwhile, every deduction he hopes to eliminate has an army of defenders equipped with reams of data. And the plan is suffering even more from the charge that it would drain tax revenues at a time when we have mammoth deficits.

Many of these problems are the natural result of the difficulty we face when we try simultaneously to lower marginal tax rates and broaden our tax base. These are the key and necessary components of any good tax reform plan. But can they be accomplished at the same time? Yes — if Mr. Reagan is willing to try a simpler and more balanced approach.

The President's plan lowers the top marginal tax rate to 35 percent and recaptures revenue by selectively eliminating certain deductions and credits, such as state and local taxes and the investment tax credit. We think he can lower the rates even further without a frontal assault on politically sensitive deductions.

Our plan halves the value of the huge collection of deductions in exchange for much lower tax rates. We do not do this by wholesale elimination of deductions, but by an across-the-board devaluation of them. That, combined with lower rates, would encourage work and investment while discouraging high-income itemizers and corporations from using their energies to find or protect tax angles.

The plan has two basic parts. First, there would be three brackets: 15 percent, 23 percent, and a top rate of 30 percent for incomes of over $70,000. Second, we would "flatten" the value of tax breaks, making them equal for all taxpayers, instead of the present system under which each deduction or exemption is worth 50 cents on the dollar for a wealthy taxpayer and only 14 cents on the dollar for a low-income taxpayer. We would make all deductions and exemptions for all taxpayers, including corporations, worth 15 cents on the dollar. And we would convert that to a credit against taxes owed.

Consider, for example, a couple earning $60,000, with exemptions and deductions worth $12,000. Their taxable income is $48,000. Under the current system, they owe $10,616 in taxes. Under our plan, their $12,000 in deductions becomes a tax credit worth 15 percent of that, or $1,800, that comes off the top of their tax bill. That bill would be figured by taxing their income of $60,000 at the lower rates: 15 percent on the first $27,000 and 23 percent on the next $33,000 for a total of $11,640. After subtracting the $1,800 credit, they would have a final tax bill of $9,840, about 8 percent less than under the current system.

One more modification would be required to incorporate existing tax credits (as opposed to exemptions and deductions) into the system at the same level. We would cut in half existing credits (such as the investment tax credit) to approximate the overall halving of the value of deductions.

This plan is fairer than the President's for three reasons. First, it does not single out any tax preference for elimination, but uniformly reduces the value of all. Second, it means that no individual or corporation can avoid paying taxes. Third, it places more of the burden of base-broadening on high-income individuals and corporations, thus compensating for the fact that corporations and high-income individuals will be receiving a larger percentage reduction in their tax rates. The combination of lower marginal rates and a cap on tax preferences will mean a more stable tax system, because both will operate to take the starch out of any future drive in Congress for tax breaks.

And there is an additional political advantage. By retaining deductions but lowering their value, we take the high ground away from special interests arguing to retain a piece of the pie. To fight our plan, they have to argue in favor of higher tax rates — an argument that won't wash with Congress or the public.

Who would lose? Take a family of four whose income is $100,000 and whose aggressive use of tax shelters allows them itemized deductions totalling $43,000. Under the current system that family would pay $13,646 in taxes. Under our system deductions, exemptions, and exclusions would be converted into a tax credit of $7,800. Given the 15-23-30 three-bracket system, their tax would be $15,140, about 11 percent higher than it is now.

It would also be impossible to avoid tax under our system. Suppose a corporation had an income of $100 million with deductions, exemptions and exclusions equal to that amount. Under the current system, no tax would be due. Under our system, in which the corporate rate is 30 percent, the corporation would owe $15 million — 30 percent of $100 million less a credit of $15 million equal to 15 percent of its $100 million in deductions, exemptions and exclusions.

**We can lower rates and broaden the tax base**

The plan also reduces the current system's disheartening tax disincentives to earning extra income. If our $60,000 couple worked harder and earned $70,000, under our system they would get to keep $7,700 of the additional $10,000 without seeking any tax shelters. Under the current system they would get to keep only $8,210.

How much revenue could be expected from the 15 percent cap on tax preferences, and how far could rates be reduced? The revenue loss from tax breaks under the current system averages about $450 billion annually over the next five years. The 15 percent cap on tax preferences under our plan, including the personal exemption, would aim at nearly halving existing preferences and could achieve a base-broadening revenue increase of about $200 billion annually.

By contrast, the President's plan would in effect be revenue-neutral, "losing" about $120 billion a year over the next five years by reducing rates and giving additional exemptions to low-income families, while recapturing roughly this amount by selectively eliminating loopholes and preferences. The extra revenue our plan raises could be used to get the top marginal rate down to below 30 percent while still yielding a comfortable margin of safety.

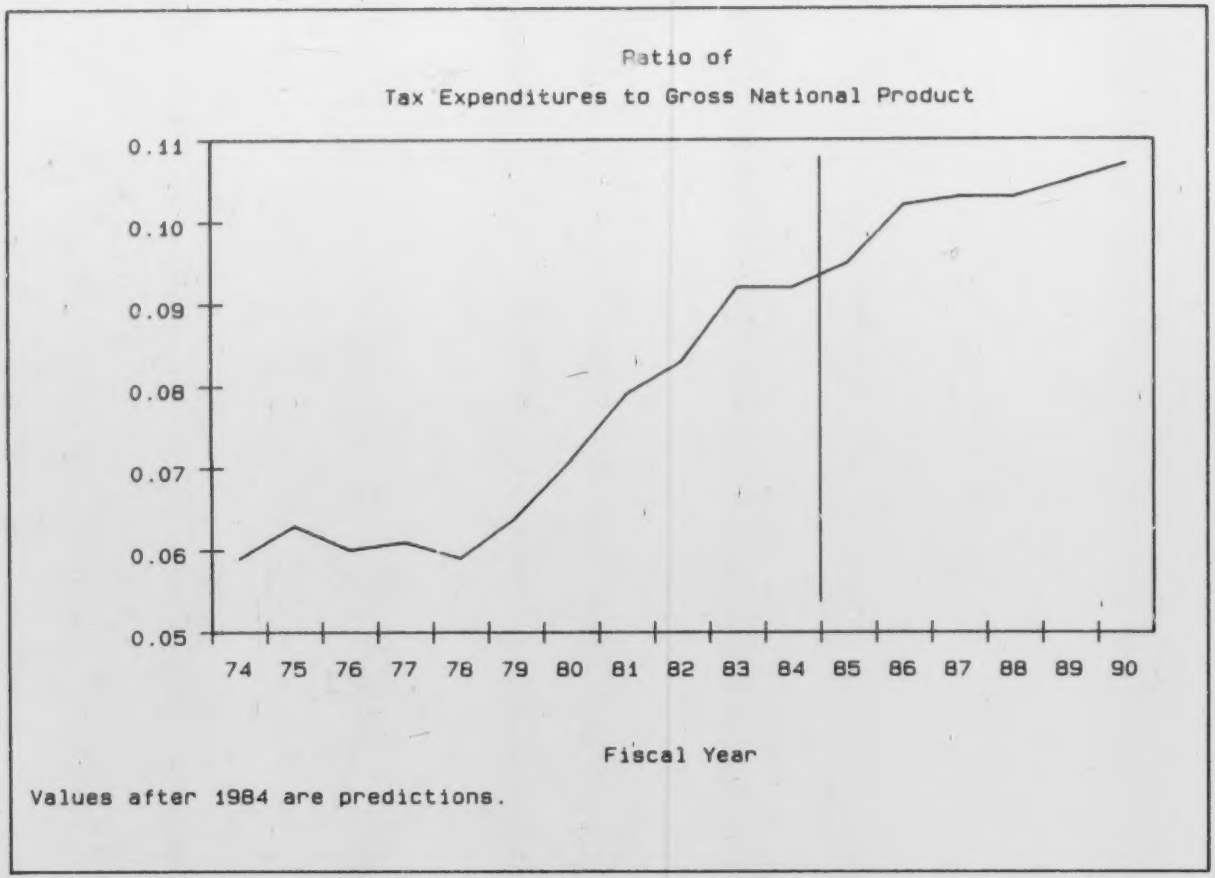
As with any fundamental change, this system would impose burdens on heavy users of tax preferences. The costs of a transition to a new system could be reduced by gradually phasing in the system over a period of years. One route would be to begin by capping deductibility at 35 cents on the dollar in 1986 and moving down in increments of 5 percentage points per year to 15 cents on the dollar in 1990. Marginal rates over that period could also be continually adjusted to maintain revenue neutrality.

This is not an "all or nothing" plan. Congress can select the degree and pace of reform. The President's insistence that tax reform be "revenue neutral" and Congress's nervousness about deficits can be be accommodated by phasing in lower rates gradually while accelerating base-broadening. Thus, the plan could raise revenues in the first couple of years to reduce deficits, but give more tax breaks later to make the plan revenue-neutral over five years.

This plan is obviously not as pure as the total elimination of all exemptions and preferences. But that is simply politically impossible. In the real world, the concept of base-broadening that touches everyone equally seems the best way to achieve the goal of lower tax rates and, in broader terms, a tax system consistent with fairness, growth and simplicity. □

*John H. Makin is director of fiscal policy studies at the American Enterprise Institute and Norman J. Ornstein is a resident scholar at the institute.*

TABLE 1




Values after 1984 are predictions.

TABLE 2

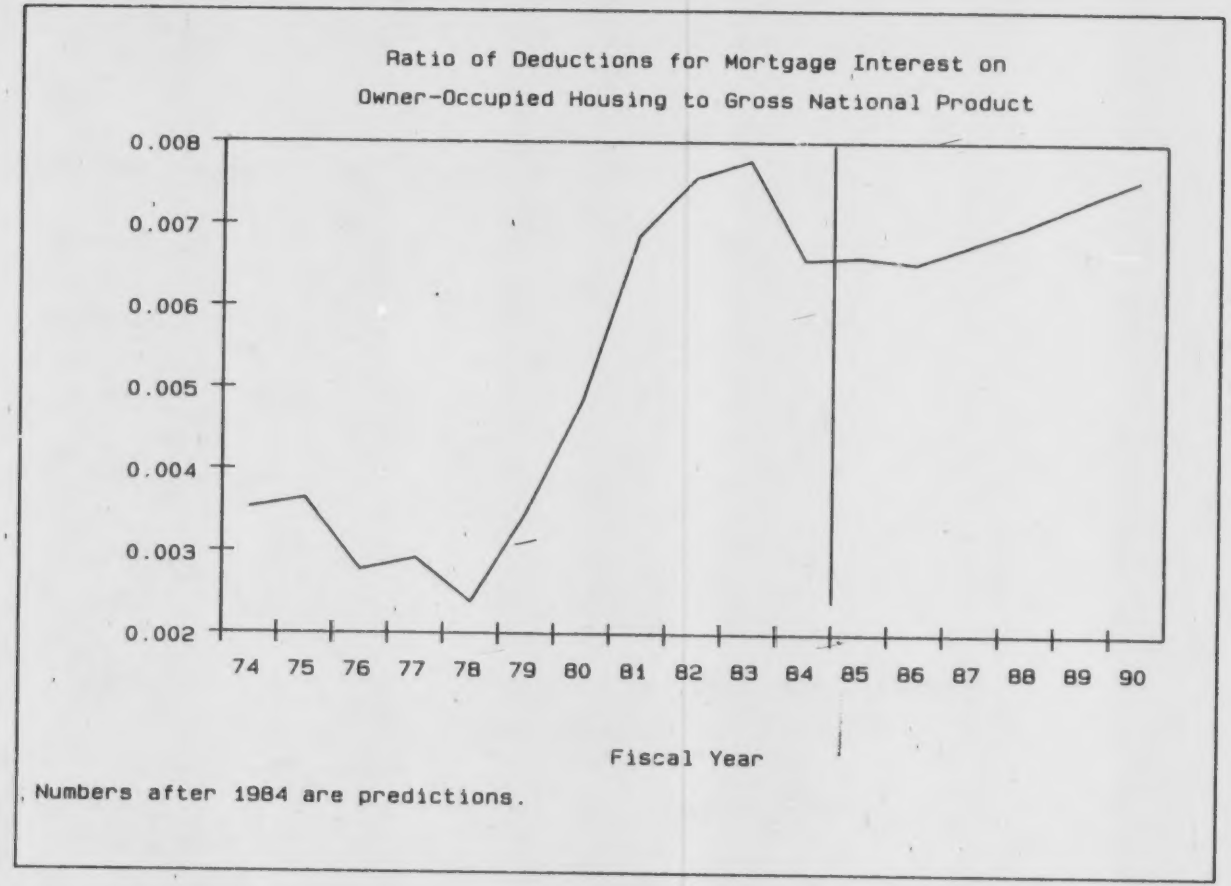
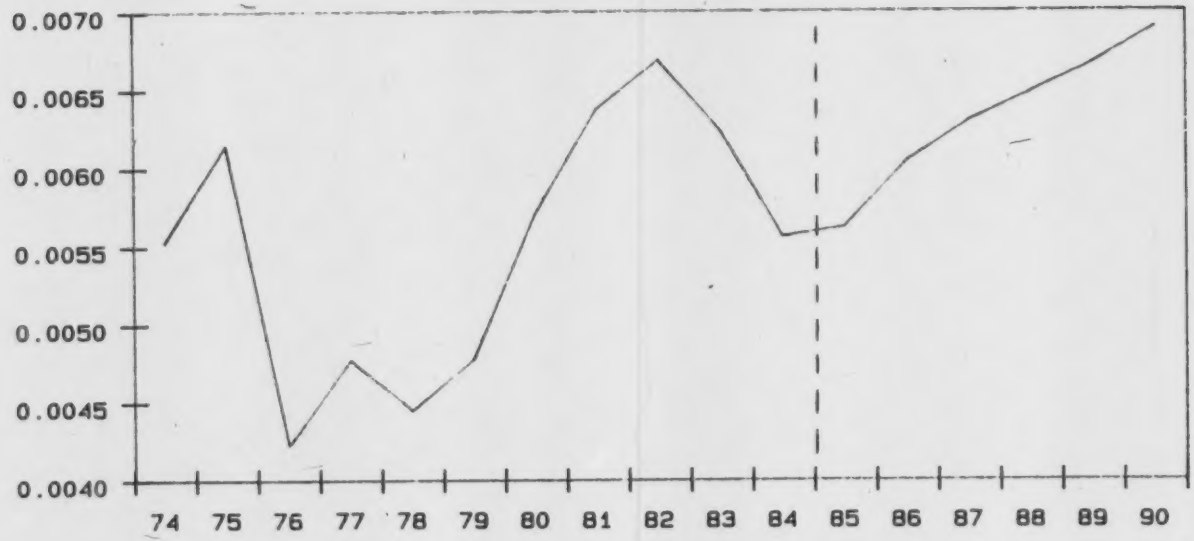

Ratio of Deductions for Mortgage Interest on
Owner-Occupied Housing to Gross National Product
0.008
0.007
0.006
0.005
0.004
0.003
0.002
74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90
Fiscal Year
Numbers after 1984 are predictions.

TABLE 3

# TAX EXPENDITURES/GNP:

## DEDUCTIBILITY OF NONBUSINESS STATE AND LOCAL GOVERNMENT TAXES



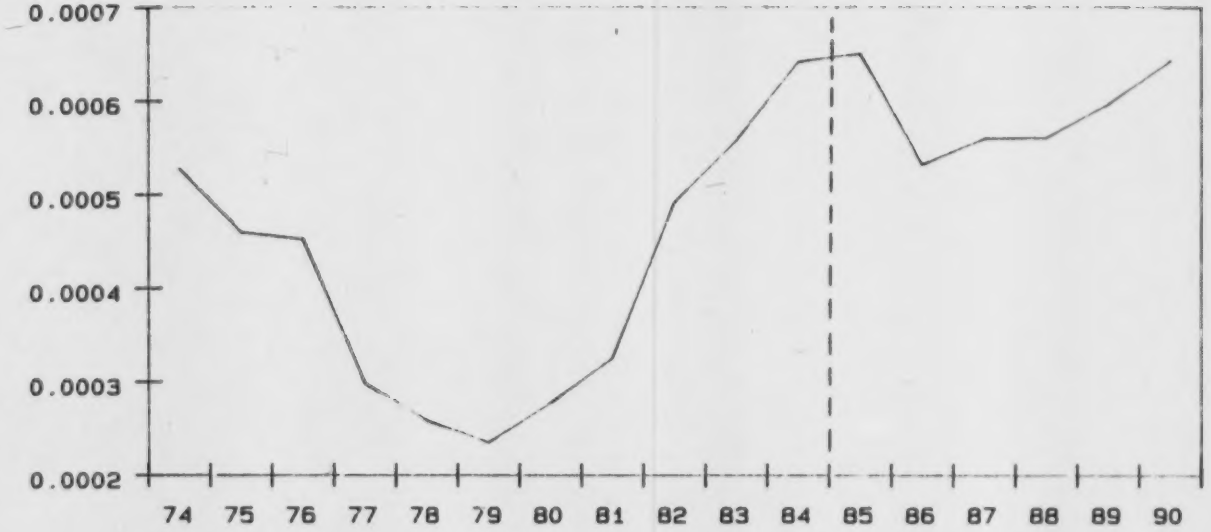

Values after 1984 are predictions.

TABLE 4

# TAX EXPENDITURES/GNP:

## CAPITAL GAINS

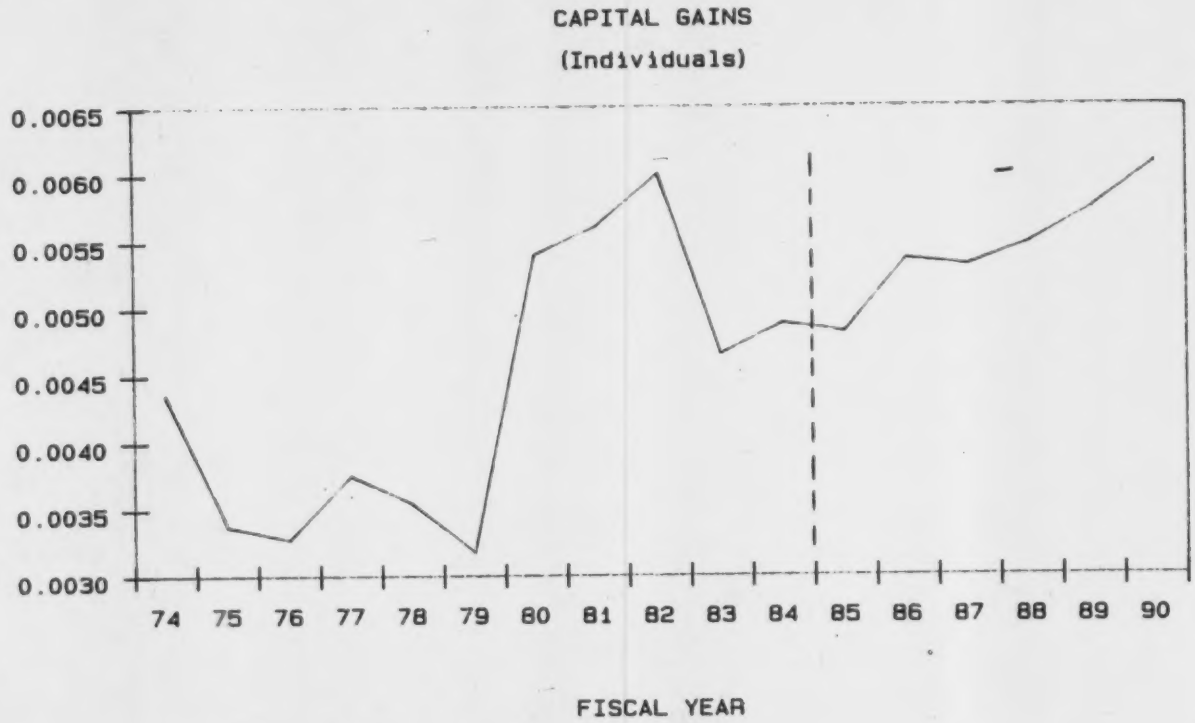
## (Corporations)




Values after 1984 are predictions.

TABLE 5

# TAX EXPENDITURES/GNP:

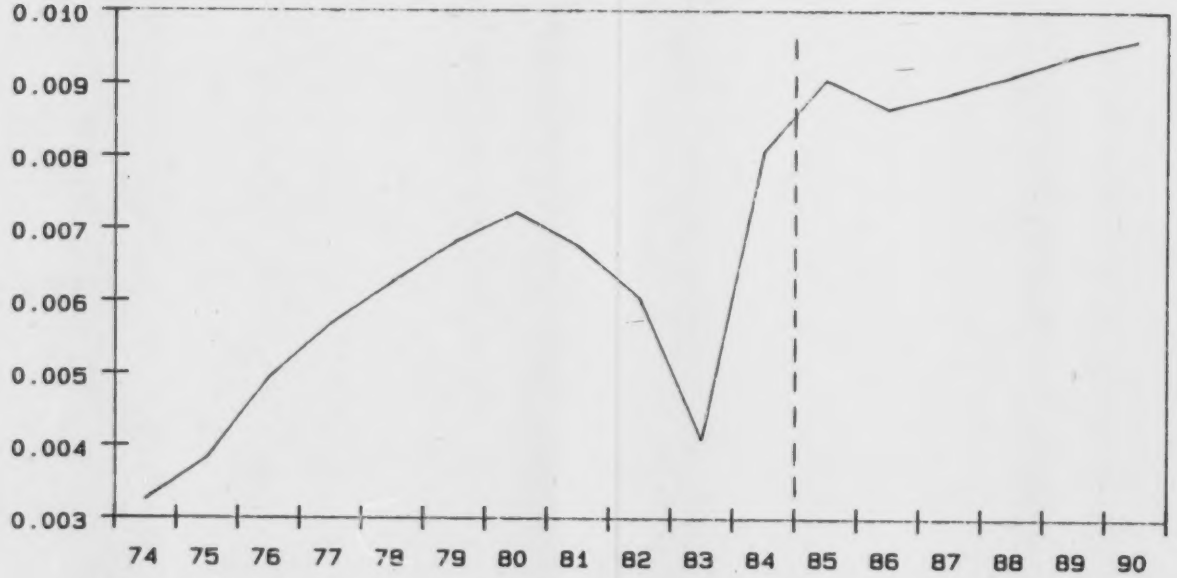



Values after 1984 are predictions.

TABLE 6

# TAX EXPENDITURES/GNP:

## INVESTMENT TAX CREDIT

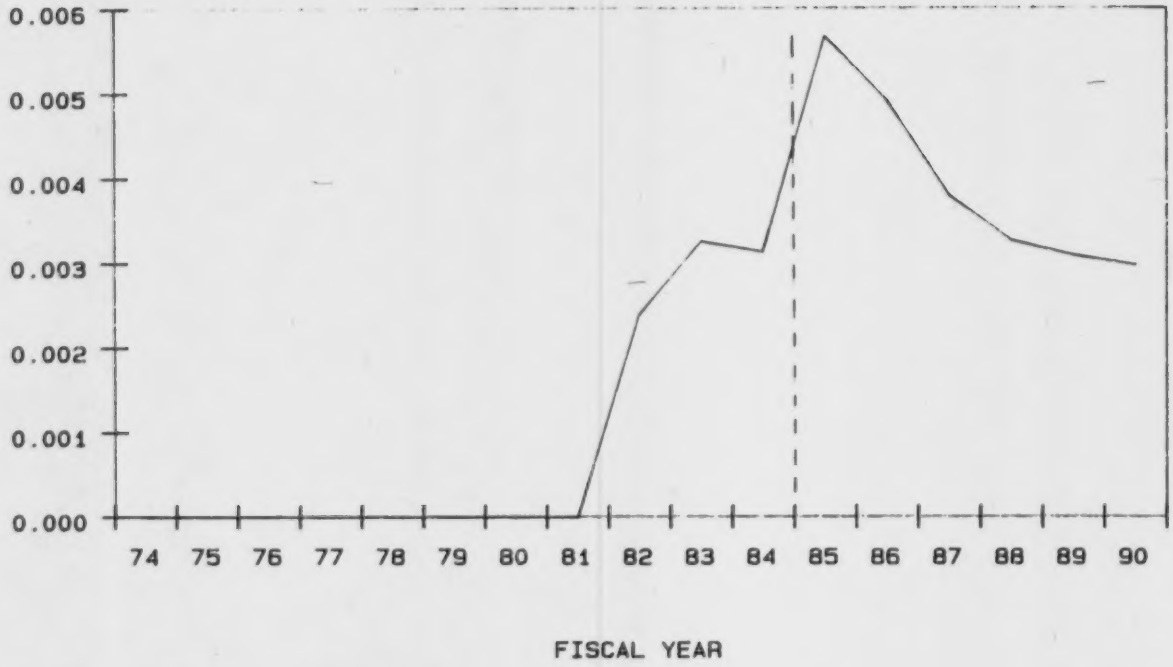



Values after 1984 are predictions.

TABLE 7

# TAX EXPENDITURES/GNP:

## ACCELERATED DEPRECIATION




Values after 1984 are predictions.

Sources:

1. Tax Expenditures

| Year | |
|---|---|
| 1974 | Estimates of Federal Tax Expenditures, July 8, 1975 |
| 1975 | Estimates of Federal Tax Expenditures, March 15, 1976 |
| 1976 | Estimates of Federal Tax Expenditures, March 15, 1976 |
| 1977 | Estimates of Federal Tax Expenditures, March 15, 1977 |
| 1978 | Estimates of Federal Tax Expenditures, March 14, 1978 |
| 1979 | Estimates of Federal Tax Expenditures for Fiscal Years 1979-1984, March 15, 1979 |
| 1980 | Estimates of Federal Tax Expenditures for Fiscal Years 1980-1985, March 6, 1980 |
| 1981 | Estimates of Federal Tax Expenditures for Fiscal Years 1981-1986, March 16, 1981 |
| 1982 | Estimates of Federal Tax Expenditures for Fiscal Years 1982-1987, March 8, 1982 |
| 1983 | Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988, March 7, 1983 |
| 1984 | Estimates of Federal Tax Expenditures for Fiscal Years 1984-1989, November 9, 1984 |
| 1985 | Estimates of Federal Tax Expenditures for Fiscal Years 1984-1989, November 9, 1984 |
| 1986 | Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990, April 12, 1985 |
| 1987 | Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990, April 12, 1985 |
| 1988 | Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990, April 12, 1985 |
| 1989 | Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990, April 12, 1985 |
| 1990 | Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990, April 12, 1985 |

2. Federal Budget Receipts, Federal Budget Outlays

| Years | |
|---|---|
| 1974-1984 | Economic Report of the President, February, 1985 |
| 1985-1990 | Congressional Budget Office, Baseline Estimates, February, 1985 |

3. Gross National Product

| Years | |
|---|---|
| 1974-1984 | National Income and product Accounts |
| 1985-1990 | Congressional Budget Office, Baseline Estimates, August, 1985 |

Footnotes:

1. Investment Tax Credit:
   a. 1979-1980: other than for TRASOPs and rehabilitated structures
   b. 1981: other than for ESOP's, rehabilitation of structures, and energy
   c. 1982-1983: other than for ESOP's, rehabilitation of structures, reforestation, and leasing
   d. 1984-1990: other than for ESOP's, rehabilitation of structures, reforestation, leasing and energy property

2. Accelerated Depreciation: on equipment other than leased property

3. Deductibility of Nonbusiness State and Local Government Taxes: other than on owner-occupied homes

4. Capital Gains:
   a. 1974-1976: other than on agriculture and timber
   b. 1977-1990: other than on agriculture, timber, iron ore, and coal

Dr. ORNSTEIN. Thanks, Mr. Chairman. I am going to move on beyond what John said, to talk a little bit about some of the broader problems that I think this committee faces and why John and I began to move in the direction that we did, sensitive both to the need for change in the tax system and certain goals that all of us would share and to the elements of the political process that make some kinds of change particularly difficult; others easier to bring about but with less positive effects. It seems to me that, as you go about the process of changing the Tax Code, you have got to start first with something that is fair in its implementation and fair in the distribution of burdens.

When we start to get into a process where interests can suggest, as many are now, that this is not going to be implemented fairly, that in the process of changing the Tax Code some are going to get away with murder while others will bear a heavier burden, you run into an immediate and enormous difficulty. And in a similar fashion, when you begin to make these changes, there are already charges that the burden will not be distributed fairly, as the Ways and Means Committee is going about this process now, already trying to jigger around the rates so that they can make sure that the wealthy a significantly higher share. Having a system that is fair in the implementation so that nobody in the process of change feels that they are being singled out is, I think, necessary to bringing about significant change, as well as a system that distributes the burdens fairly.

Second and obviously, if we are not just going to go through the exercise of changing the Tax Code so we can change the Tax Code, or changing the Tax Code because the President wants to change the Tax Code, we want to bring about a change that really does have positive effects, that we would all share from tax reform. And those are, it would seem to us, very clearly you want a Tax Code that distorts economic investment less—little if possible—but certainly less than what we have got now. Something that encourages greater work and productivity, and as John suggested, something that brings more stability to the system, that has built into it less incentive for interests on the outside to keep pushing for change, pushing for more things. Now, the current process of bringing about change, and particularly what we see going on now on the House side, moving from the revised package that the President sent down, I believe it is deeply flawed.

Already we are seeing some of the basic goals of tax reform slipping away as some in the Ways and Means Committee are moving and will probably succeed at increasing tax rates by adding a fourth bracket, pushing it up to 40 percent. We believe that probably the primary goal that you want to achieve out of tax reform is to lower those marginal rates. There is an inherent drive in the legislative process, as we all know. Once a plan comes down, to dilute it. The pressure is there to give people back something that they perceive as being done to penalize them unfairly. And in the end, I suspect we are going to get a bill, but it may well be very little. It might be positive in a marginal way, but it will probably end up being so twisted and torn and diluted that it is simply going to bring the pressure right back again to go through this exercise

the next year and the year thereafter and there will be no stability provided to the process.

Now, one other problem that we have tried to address. As we all know, putting together tax reform with revenue neutrality is exceedingly difficult. And it is exceedingly difficult particularly as we begin to talk about some of the other pressures that face the economy, including the deficit, but it is difficult simply to work through politically. We believe that moving to a concept of revenue neutrality over a longer period of time—5 years or more—phasing in differentially the provisions that would cut back on the percentage of deductions and that would phase in the tax rates in a differential way would give Congress great flexibility at bringing about fundamental tax reform without having to go through the enormous difficulty and perhaps impossibility of trying to, in 1 year, implement totally tax reform and revenue neutrality at the same time.

You might be able to solve a considerable number of problems at once if you do that. All of those things, I think, are behind the reasoning for the option that we have presented. It is as simple as could be in its implementation without getting so simple that it simply doesn't make sense in a complex international economy. It is fairly administered. It cuts across everybody in an even fashion, and it enables us to tax those who are taking advantage of the system much more fairly than they are now, while also providing lower rates and a real incentive for people to save and invest.

Senator GRASSLEY. Because the hour of 12 is coming closely, I am going to have to dismiss this hearing. I want to apologize because obviously where you folks come from and your expertise in this area, we ought to be taking advantage of you more than we are able to at this particular time; but I do have an appointment at 12. So, let me adjourn the hearing, and thank you very much.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Hearing on Alternative Tax Reform Proposals-Oct.10,1985

TAXATION WITHOUT DISCRIMINATION (TWD)

SR1, Box 23-A, New Castle, Va. 24127, 703-864-5949
Statement of Fortescue W. Hopkins, Director
Committee on Ways & Means
Hearings on Comprehensive Tax Reform

RE: Discriminatory Tax Laws

Mr. Chairman:

Today, ours is not a Government of, by and for the people. Instead, it is a Government of, by and for "ORGANIZED MINORITIES", who, with Millions of dollars in tax-free PAC contributions to or for the principal benefit of the members of the Tax Writing Committees of Congress, attempt to persuade these members to enact or to maintain discriminatory tax laws for their benefit. See Tax Notes, 8/19/85, P.922, Appendix "A", herein.

In many, if not most, instances, "Discriminatory Tax Laws" result in Congress doing "indirectly" what it would not have the power under the U.S. Constitution to do "directly". In the mean time, since the "Switch in Time to Save Nine"(1937) and having inundated themselves and all Federal Courts with extensive litigation resulting from a confused and expansive interpretation of the application of the 14th Amendment, the Justices of the Supreme Court (the "SUPREMES") are now and have been unwilling to accept their clear responsibility to curb an ever accelerating degree of discriminatory tax laws &"tax subsidies" intended to achieve non-revenue related objectives not authorized under any provision of the Constitution.

TWD hopes to have (or to be) the PAC that truly represents the "total point of view of all Americans", whether organized or not. It will, however, not contribute one thin dime to or for the benefit of any member of Congress or any candidate for national office. TWD will use its funds, primarily, for the following purposes:

1. With the help of PATRICK HENRY*, WALTER K. TULLER**(see Appendix B, herein) and the brightest independent minds available (legal or otherwise), to convince the American people that the SUPREMES have greviously erred in their failure to protect the individual citizen's Constitutional Right not to be subject to discriminatory tax laws intended to achieve non-revenue related objectives where such discrimination or objective is not authorized under any provision of the U.S. Constitution with the sincere hope that the SUPREMES (or, at least, five of them) will take cognizance of the resulting adverse public opinion to the extent that they will, then, recognize their duty and rule, accordingly.

*PATRICK HENRY'S testimony before the Virginia Constitutional Convention of 1788 See Elliotts Debates, The Michie Company, Charlottesville,Va.

**WALTER K. TULLER'S persuasive analysis of the Constitutional aspects of discriminatory taxation contained in his book, THE TAXING POWER/ STATE INCOME TAXES, Callaghan and Company(1937), the last 13 pages of which are attached hereto as Appendix B.

2. To contribute to the campaigns of state legislators who will vote for and support a call for an "OPEN CONSTITUTIONAL CONVENTION" under Article V of the U.S. Constitution to consider needed amendments to the U.S. Constitution, including:

THE TAX MAGNA CARTA

"CONGRESS SHALL MAKE NO TAX LAW THAT IS, IN THE SLIGHTEST DEGREE, DISCRIMINATORY OR INTENDED TO ACHIEVE A NON-REVENUE RELATED OBJECTIVE, WHETHER OR NOT SUCH DISCRIMINATION OR OBJECTIVE IS AUTHORIZED UNDER ANY PROVISION OF ANY CONSTITUTION."

[The foregoing proposed Amendment is considered a "base line definition". Of course, such other exceptions as may be desirable (religious, corporate-individual intergration, foreign, etc) can be

added by a Constitutional Convention (or proposed as Constitutional Amendments by Congress). This way you have "Tax Reform" from the "bottom up" and not from the "top down", the only way any meaningful Tax Reform can possibly be accomplished.]

3. To defuse the political power of "ORGANIZED MINORITIES" and to make our Representative Democracy truly "Representative", State Legislators will also be asked to consider a number of needed Constitutional Amendments including one concerning PACS:

"NO CONTRIBUTION OR EXPENDITURE TO OR FOR THE BENEFIT OF THE CAMPAIGN OF ANY CANDIDATE FOR PUBLIC OFFICE WILL BE ALLOWED EXCEPT BY THE INDIVIDUAL REGISTERED VOTER OF THAT CANDIDATES DISTRICT AND, THEN, IN ONLY SUCH AMOUNTS AS PERMITTED BY THE STATE LEGISLATURE AND, FURTHER, THAT ALL SUCH AMOUNTS WHEN RECEIVED OR EXPENDED WILL BE TAXABLE AS INCOME TO THE CANDIDATE AND NO DEDUCTION OR TAX CREDIT WILL BE ALLOWED FOR THE CONTRIBUTION OR EXPENDITURE."

[If TWD attains the foregoing objective, it will truly be the "PAC TO END ALL PACS".]

CONCLUSION

PATRICK, TWD promises you that, despite the incalculable damage inflicted on America by your refusal (or inability) to accept George Washington's appointment of you as Chief Justice of the Supreme Court, your great dream of INDIVIDUAL POLITICAL RESPONSIBILITY, INDIVIDUAL ECONOMIC OPPORTUNITY, INDIVIDUAL RELIGIOUS FREEDOM AND INDIVIDUAL PERSONAL LIBERTY will not be allowed to die. TWD will re-acquaint the American people with your testimony before the Virginia Constitutional Convention of 1788, and when they test your common sense observations and predictions against current events and the events of the past two hundred years, they will believe, and you will assume your rightful place in Americas' History as our GREATEST PATRIOT. Recently, at

Williamsburg, President Reagan referred to you as the "Father of the First American Tax Revolution". It may well be that you and WALTER K. TULLER will be the Fathers of THE SECOND AMERICAN TAX REVOLUTION.

WALTER, nearly 50 years ago, you stated at the end of your classic book, THE TAXING POWER:

> "If the courts permit those in control of the legislative and executive branches of the Government to tax without due regard to constitutional limitations, particularly to impose discriminatory taxes, Constitutional Liberty is dead. Whatever forms may survive, the Government will be, in fact, Absolute. Here lies our greatest and most immediate danger. The tide today is setting toward that shore. The only hope lies in revitalizing the oath, solemnly taken by every judge of every court, to maintain and defend the Constitution of the United States." (emphasis supplied)

WALTER, in the past 50 years this "tide" of discriminatory taxation has resulted in a "tower of babel" (the Internal Revenue Code) that is about to collapse of its own weight and has become a "tidal wave" far beyond your worst expectations. TWD promises you, Walter, that it will find millions of Americans to support your cause and that this "tide" will recede, gradually, at first, and then it will go out with a roar, never to return.

Respectfully submitted,

TAXATION WITHOUT DISCRIMINATION*

by Fortescue W. Hopkins
Fortescue W. Hopkins, Director

* A Virginia non profit, non-stock corporation incorporated July 2, 1984

**TAX REFORM HELPS MEMBERS OF TAX WRITING COMMITTEES RAKE IN THE PAC MONEY.** From insurance companies wanting to preserve the tax-free appreciation of life insurance earnings, the money comes; from horse breeders who want to keep rapid depreciation of thoroughbreds, the money comes; from military contractors who want to retain favorable tax treatment of earnings from multiyear contracts, the money comes. All of it flowing to House and Senate members, and thanks to tax reform fever, a hefty chunk of the money is going to members of the tax writing committees. The politicians' hunger for money is so great, *The Wall Street Journal* reports, that it is beginning to draw groans from lobbyists, who say that they have never seen such appetites for contributions in a non-election year and that the politicians are holding too many fund-raising events too early, at too high a price.

The *Journal* writes that members of the Finance and Ways and Means Committees have nearly tripled their take from political action committees (PACs) during the first six months of 1985, to $3.6 million, compared to a similar period in the past two-year election cycle. According to the *Journal*, the tax writers, who account for about 10.5 percent of all House and Senate members, received 23.5 percent of all PAC money raised by incumbents. The leading PAC beneficiary on Capitol Hill is Finance Committee Chairman Bob Packwood, R-Ore., who raked in $691,015 from PACs from January 1 to June 30 of this year. (A spokeswoman for Packwood discounted any notions that he may be unduly influenced by the money, saying, "In Packwood's mind a PAC represents the sum total point of view of American workers.") Senate Majority Leader Robert Dole, R-Kans., and Sen. Steven Symms, R-Idaho, both Finance members were, respectively, the second and fourth highest PAC beneficiaries in the Senate. In the House, Ways and Means members Sam Gibbons, D-Fla., Henson Moore, R-La., and Pete Stark, D-Calif., were first, third and sixth, respectively.

Robert McIntyre of Citizens for Tax Justice says a "bright side" of the PAC boodle is that Congress members "might be trying to get the money now because after they do what they are going to do nobody will want to give them money anymore," but he adds that the money may lead them away from real tax reform. Others speculate that the flood of early money will give incumbents an even greater edge than in the past.

Meanwhile, Senate Finance Committee member Russell B. Long, D-La., the Committee's ranking minority member who is retiring next year, says he will be returning $360,543 in campaign contributions to individuals and PACs. *The Wall Street Journal*: Brooks Jackson, 8-9-85, p. 36. *The Washington Post*: (AP wire), 8-10-85, p. A2.

**TAX NOTES, August 19, 1985**

APPENDIX "A"

417

The taxing power is admittedly broad. So long as the burden is uniform, it may be that the citizen has no redress in the courts. But uniform taxation and discriminatory taxation are different things. They are different in concept and essentially different in effect. The very purpose of a discriminatory tax is to burden different citizens or different classes of citizens unequally. Its effect is or well may be to destroy one citizen and build up another. We have after all a Constitutional Government—not an Absolutism. One of the reasons why we have a Constitutional Government is because of the abuses which are possible under an Absolutism. One of the most potent of those abuses is the power to impose discriminatory taxes. Due process of law and equal protection of the laws are not idle terms. They were placed in the Constitution for a purpose. That purpose was to guarantee practical equality before the law to all citizens and to prohibit this Government from engaging in those practices common to despotic governments, among others, discriminatory taxation. Granting that the Government has some power to levy discriminatory taxes, still that power must be limited by constitutional principles else we do not have a Constitutional Government. It may be difficult to lay down any hard and fast rule as to just where those limits are.

But it is not possible that the Legislature is limited only by its own ideas of "Social Justice." This, we repeat, would mean that it is not limited at all. As nearly as the rule can be expressed in words, it is suggested that it should be substantially this: That the Legislature may discriminate in taxation in those cases, and *only* in those cases, where it might similarly discriminate by direct, substantive legislation. Where the Constitution prohibits that, it is believed it necessarily prohibits the accomplishment of the same end by the means of discriminatory taxation.

The Author makes no claim that this is the law today. There are many cases which are contrary to these views. There are also a number of cases that are entirely consistent with them. As stated at the beginning of this Chapter, it is believed fair to state that the law on this subject is far from settled. The method of treating each case by itself, with very little regard to fundamental concepts, has failed. Its result has been a multitude of inconsistent and irreconcilable decisions, frequently rendered by a bare majority of the court. It has brought the law on this subject into the utmost confusion. Yet it is a subject of the utmost importance. If wrong principles are allowed to prevail, it may result in disaster to our entire constitutional system. We have not attempted in this Chapter to try to bring order out of the chaos of decided cases. We have endeavored to analyze, as a matter of sound principle, what limitations the Constitution itself imposes and necessarily imposes upon the power of the Legislature to lay discriminatory taxes upon the citizen. We have sought to point the truth, which must be clear to any one who will consider and fairly face the facts, that the present tendency to permit to the Legislature ever-widening powers to impose discriminatory taxes on the citizen must be checked—that unless it is checked Constitutional Liberty will inevitably be destroyed.

## CHAPTER XX

### CAN CONSTITUTIONAL LIBERTY BE PRESERVED

The answer will probably be given by the courts. At first impression this may seem a strange statement. Upon reflection, it is believed the truth of it will be evident. The great danger of the loss of our liberties lies within, not without, this country. The danger of conquest by a foreign foe can fairly be said to be remote. The danger that some day there may be a revolution attempting to set up the dictatorship of the Proletariat is more real. But the success of such a movement seems unlikely. The danger that we, ourselves, may, more or less blindly, destroy our own liberties, is a very real danger. Two means, either of which may accomplish this end, are constantly with us. One is Bureaucracy, exercising well-nigh despotic powers incompatible with Liberty. The other is unjust and particularly discriminatory taxation under which the Legislature may exercise practically despotic powers equally incompatible with Liberty. Whether the Courts have the vision and the courage to restrain these within the limitations of the Constitution will probably determine whether Constitutional Liberty shall survive or perish.

Of what does Constitutional Liberty consist? We Americans have taken it so much for granted that we have seldom taken the time to consider what it is. In essence it consists of this: That the Constitution forbids the Government to infringe certain rights of every citizen, and provides a means whereby any attempt by the Government to infringe those rights of any citizen can be and will be nullified. Both the prohibitions upon the

power of the Government and the means by which, as a practical matter, any attempted exercise of a prohibited power can be and will be nullified, are essential to Constitutional Liberty. Thus, constitutional limitations upon the power of the Government and the willingness of the Courts to strike down any attempt on the part of the Government to exercise a prohibited power, are indispensable to the preservation of Liberty. If either fails Constitutional Government and Constitutional Liberty dies. Whatever outward forms may be preserved, the Government becomes an Absolutism. There will follow the rule of the Monarch, the Dictator, or the Mob.

Except for constitutional limitations, and except there be tribunals having the power, and willing to exercise the power, to strike down unconstitutional acts by any department of the Government, the Government may do anything. Under a Government that may do anything, the citizen has no rights and no liberties. The Government may allow him some privileges. If it does, it is simply as a matter of grace. It may deprive him of them at the pleasure or caprice of those in control of the Government. A people living under the heel of such a Government is not and cannot be a free people. We repeat, Liberty exists only where each citizen has rights which the Government has no power to infringe and where, if it does attempt to infringe them, the citizen has a practicable remedy by which that attempt will be nullified and his rights protected. This is just as essential as the right itself. Of what value is a right unless it can be enforced and protected? Obviously a citizen cannot defend himself by force against the Government. Hence, if the constitutional rights and liberties of citizens are to have any validity, the courts must have the power to enforce and protect them against action by the Government itself. Otherwise whatever the Constitution may say, the fact is that the Government is absolute and there is no Liberty.

But it is not enough that the courts have the *power* to nullify the action of the Government when it violates constitutional rights. They must also be *willing* to do so. This involves two essential elements: *1st:* A state of mind wherein the preservation of the constitutional system and the liberties of the people guaranteed by the Constitution transcends any supposed expediency—whether it be called general welfare, social justice or what-you-will; *2nd:* The moral courage to uphold and preserve the liberties of the people even against themselves. Time and again the popular mind is carried away by movements which would result in breaking down constitutional limitations and in destroying the liberties of the very people who most loudly advocate the movement. It cannot too often be repeated that Liberty can exist only in a state where limitations upon the power of the Government not only exist on paper but are fearlessly enforced in fact.

In a simple civilization the task is relatively easy. In a civilization as complex as ours has become it is probably the most difficult task to which Mankind has ever set his hand. The pressure to whittle away the constitutional limitations on the power of the Government and so gradually to destroy the constitutional liberties of the citizen is unceasing and well-nigh irresistible. Only if the courts vigorously and courageously resist all encroachments by legislative or executive power—only as they fearlessly apply the principle *obsta principiis*—can the destruction of these constitutional principles be averted. (Compare ante, pages 8, 10.)

Our Government has become—and inescapably so—a Government of organized minorities. Organized minorities want something. It is for that purpose that they are organized. Usually they want something for themselves. Usually it is at the expense of the rest of the people. The rest of the people are unorganized. The country is too vast, the problems of economics, of social

policy, of finance, and of all the various inter-relations of present-day life are too complex, for the general public to be organized for effective political action. Hence, they are at the mercy of the Government, which means, in fact, at the mercy of the organized minorities who can gain control of the Government. What protection have they for their rights and liberties? None, except as the courts resist and strike down every act of the legislative and executive departments which infringes upon them.

Time and again in human history great civilizations have broken down and peoples have perished. Why? Historians suggest various reasons. The Author begs leave to suggest one reason that seems common to all and that probably has its foundations in some basic principle of mass psychology. It is this: The civilization became too complex for the understanding of the average man. Hence, it fell of its own weight. A simple civilization seldom falls. The average man can understand its problems. Understanding them he can find an answer for them and can meet them. But our civilization today is the most complex that the world has ever seen. It is trite to say that the average man cannot understand it. The plain fact is that no one understands it. The complicated inter-relations of present-day life, social, economic, financial, industrial, international, are beyond the grasp of the wisest.

But there is one thing which we can all understand. That is our American constitutional system. It consists of a Government created by the Constitution—a Government whose powers are not absolute, but are limited by the Constitution—and whose citizens have rights and liberties that are above and beyond destruction or infringement by any act of the Government. This is fundamental and should be unchangeable. Citizens have certain basic rights whether the civilization is simple or complex. These rights must be preserved against any action of the Government—otherwise they are not rights.

There is a constant effort on the part of the Government, sometimes conscious, sometimes unconscious, to break down those rights. This is true no matter what the form of Government. It is just as true in our so-called popular Government, that is, our Government of and by organized minorities, as in any other form. Perhaps it is more true under our form, for the control of the Government and hence, the things which those in control want for themselves, is subject to constant change.

It is only human nature that those who have won control of the Government, usually after bitter political strife, should be intolerant of any limitations on their freedom of action. They have fought and won. They fought to accomplish some purpose. Shall a mere Constitution thwart them? If the Constitution is in the way, so much the worse for the Constitution. They immediately set themselves to find some way to circumvent it. This is natural and inevitable. Those in control of the Government solemnly resolve by legislative enactment that the measures they advocate will advance the general welfare and promote social justice. Under our system, if there is any reasonable basis for the conclusion, legislative determination of what will advance the general welfare or promote social justice is final.

Hence, if the courts accept the argument that the Government may do anything that will advance social justice, that acceptance writes the death warrant of constitutional limitations and of Liberty. If the legislative and executive departments may do anything that they believe will advance social justice, then the Constitution is no longer the supreme law of the land. The will of the group in control of the legislative and executive departments at the moment is the supreme law of the land. Both cannot be supreme. If they come in conflict, one or the other must yield. The people who created the Government have declared that the Constitution is the supreme law of the land. If it is, the action of the legis-

lative or executive branches which conflicts with the limitations in the Constitution is void, *even though it is action which would advance social justice.* Otherwise the limitations in the Constitution upon the powers of the Government are mere idle words, without force or meaning.

Herein, the Author submits with all deference, lies the fundamental fallacy in the idea, so prevalent today, that if legislative or executive action will advance social justice, it must be sustained by the courts, even though it violates constitutional limitations or infringes upon the constitutional liberties of the citizen. The concept of the Constitution is that the supreme and transcendent consideration of general welfare and of social justice, to which all transitory ideas must yield, is the preservation of a Government of limited powers and of the constitutional rights and liberties of citizens of the United States. The rule of the Constitution, it is submitted, is this: That even though the executive and legislative branches believe that certain action is necessary to promote social justice, still that action cannot be taken unless it is action *within* the constitutional powers of the Government and unless it is action which will *not infringe* upon the constitutional liberties of the citizen. This must be so or the Government is not a Constitutional Government. A Government whose powers are limited only by its own views of social justice is not limited at all.

Many of us are prone to jump to the conclusion, without any adequate reflection, that if the *forms* of popular government are preserved, Liberty is safe. There can be no greater delusion. Forms of popular government are of little, if any, value in insuring Liberty. Indeed, popular government not restrained by constitutional limitations may be as destructive of Liberty as any other form of Despotism. Athens had an almost complete Democracy. It was so small that every citizen could know and understand its governmental problems. Yet

its citizens never had Liberty. The citizen of Athens held his property and even his life at the whim and caprice of any temporary majority that might gain control of the Government. Witness Aristides, to cite but a single example. The Athenians never learned the fundamental lesson that Liberty can exist *only* where there are effective limitations upon the power of the Government and upon the power of any temporary majority of the people. Hence, magnificent as were their achievements in many other lines of thought and action, and though they had popular government in its most complete form, they never had Liberty.

The fact that mere forms of Government, even the form of popular government, is no protection to Liberty was again demonstrated in Rome. Without now going into detail, it is a fact that the *forms* of popular government were carefully observed and preserved for the better part of a century after Liberty was dead and almost forgotten.

Thus, we cannot rely upon the fact that we have elections and have other forms of popular government, as any real safeguard for the preservation of our liberties. We have one hope and only one. That is in keeping alive and in full vigor of enforcement the limitations which the Constitution imposes upon the power of the Government and all its departments. We must realize that the inevitable tendency of Government, no matter who may be in control of it, is to be intolerant of restraints upon its power and to endeavor to whittle away or evade those restraints. As above noted, two of the most potent means of accomplishing this are Bureaucracy and Taxation, particularly graduated or other discriminatory taxation. Either, if unchecked, can destroy Constitutional Liberty. Of late there has been a strong tendency to give to political officials and political bodies having no judicial responsibility, the power to determine most important questions affecting the liberty of the citizen and even to

make findings of fact binding on the courts. This alone, if permitted, might well mean the end of Constitutional Liberty. It is a striking example of how little the average citizen understands the complicated forces which govern our complex civilization, that this movement has grown almost unnoticed by the public. Fortunately it seems likely that it has been or will be checked by the courts. The opinion of the court delivered by Mr. Chief Justice Hughes in St. Joseph Stockyards Co. v. U. S., 298 U. S. 38, 80 L. Ed. 1033, 56 S. Ct. 720, is, in the Author's opinion, one of the most significant and important opinions on behalf of Constitutional Liberty in this generation. It should serve to settle permanently the principal that the constitutional rights and liberties of the citizen cannot be made to depend upon findings of fact made, or other action taken by legislative, administrative, or other non-judicial bodies. It was held that when the Legislature acts within its proper sphere of legislative action, either by itself or by an agent, it may make conclusive findings, provided the requirements of due process of law are met. But it was further held that when there is presented a question whether the constitutional rights or liberties of the citizen have been infringed, the courts have the right and the duty to consider the facts independently, and determine for themselves whether such rights have been infringed. Among other things the court said (page 685):

> "The legislature cannot preclude that scrutiny or determination by any declaration or legislative finding. Legislative declaration or finding is necessarily subject to independent judicial review upon the facts and the law by courts of competent jurisdiction to the end that the *Constitution* as the supreme law of the land *may be maintained*. Nor can the legislature escape the constitutional limitation by authorizing its agent to make findings that the agent has kept within that limitation. Legislative agencies, with vary-

> ing qualifications, work in a field peculiarly exposed to political demands. Some may be expert and impartial, others subservient. It is not difficult for them to observe the requirements of law in giving a hearing and receiving evidence. But to say that their findings of fact may be made conclusive where constitutional rights of liberty and property are involved, although the evidence clearly establishes that the findings are wrong and constitutional rights have been invaded, *is to place those rights at the mercy of administrative officials* and seriously to impair the security inherent in our judicial safeguards. That prospect, with our multiplication of administrative agencies, is not one to be lightly regarded. It is said that we can retain judicial authority to examine the weight of evidence when the question concerns the right of personal liberty. But if this be so, it is not because we are privileged to perform our judicial duty in that case and for reasons of convenience to disregard it in others. The principle applies when rights either of person or of property are protected by constitutional restrictions. Under our system there is no warrant for the view that the judicial power of a competent court can be circumscribed by any legislative arrangement designed to give effect to administrative action going beyond the limits of constitutional authority."

Thus has the Supreme Court of the United States magnificently performed (even if largely unappreciated) its right and duty of preserving from one most dangerous form of attack the constitutional rights and liberties of the citizen. It is earnestly to be hoped that the courts will similarly defend those rights and liberties from the equally dangerous and destructive attacks now being made and likely to be increasingly made in the future, in the field of taxation, particularly discriminatory taxa-

tion. By this statement there is not intended the slightest suggestion of lack of courage on the part of the courts. What it is intended to suggest is how vitally important it is that the courts, as well as the public, be made to realize the fact that present tendencies and policies in the field of taxation, particularly in graduated and other discriminatory taxation, will, if permitted by the courts to be carried to their logical conclusion, inevitably destroy Constitutional Liberty—probably our entire constitutional system. If this can be made clear to the courts, one may rest confident that they will do their duty. But so complex is our economic and social system that it is often difficult to understand and appreciate the inevitable practical effects of particular taxation policies. If justification be needed for a work like the present one, it is hoped it will be found in the fact that the Author has endeavored to analyze fundamental principles and show their application to some of the practical problems of today. It is believed it is no exaggeration to state that unless the courts understand and realize the inevitable effect of present legislative tendencies in the field of taxation, and unless they fearlessly strike down taxing statutes which infringe constitutional limitations and constitutional rights, then our entire system is in grave danger of destruction.

Can our system, which consists on the one hand of constitutional limitations upon the power of the Government, and on the other of correlative rights and liberties of the citizen, long survive? We may hope but we cannot know. Already it is showing the tremendous strain and stress to which it is subjected. The old days of a simple life and a simple social, economic, and financial system are gone, probably never to return. Will a people like ours, great in number, non-homogeneous, spread over a vast territory, with diverse and frequently conflicting economic interests, long submit to those self-imposed restraints which must be preserved and main-

55-633 O - 86 - 8

tained if our constitutional system is to survive? This is the long-range view. The short-range and more immediate question is this: Will the courts, even in the face of popular clamor, firmly resist legislative encroachments upon the limitations imposed by the Constitution upon the powers of the Government particularly when such encroachments are stealthy and are proclaimed under the guise of promoting the General Welfare and advancing Social Justice? This they must do if Constitutional Liberty is to survive. Most immediate and most pressing of all, will the courts stand firm in striking down *taxing* statutes which infringe constitutional rights? Will they do this, even in the face of the claim that the Government needs the money which such statutes will raise? This is the real crux of the question. If the courts permit those in control of the legislative and executive branches of the Government to tax without due regard to constitutional limitations, particularly to impose discriminatory taxes, Constitutional Liberty is dead. Whatever forms may survive, the Government will be, in fact, Absolute. Here lies our greatest and most immediate danger. The tide today is setting toward that shore. The only hope lies in revitalizing the oath, solemnly taken by every judge of every court, to maintain and defend the Constitution of the United States.

## MAKING A BETTER FEDERAL TAX SYSTEM

A Statement by
**John C. Davidson**
Founder, The Middle Income Lobby
Submitted to Members of
Committee on Finance, United States Senate

The Lobby has been founded to develop rational and responsible policy thinking from a middle income perspective. The middle incomes are the major taxpayers of America.

For many years it has been evident that the Federal tax base is too narrow. Mistakenly some have believed this was due to personal tax deductions and exclusions so important to the middle incomes. Reflecting this mistake, the dialog leading up to the release of Treasury I was interlaced with expectations that the program would entail a substantial broadening of the base of the personal income tax. It didn't and neither does Treasury II.

It is the Federal tax base as a whole which is too narrow. There is excessive dependence on the income taxes, corporate as well as personal. One result is too much potential new capital sacrificed to government spending. Our new dependence on foreign capital accentuates the urgency for enactment of the top tax rates of 35 percent on personal income and 33 percent on corporate income proposed by the President. The legislation should provide for a real broadening of the Federal tax base. There is no reshuffling of income tax burdens which could do this.

Despite all the protestations about no tax increases, one-half of the Administration's program is composed of tax increases and the other half of tax reductions. It thus opens wide the question of the nature of a tax increase package which would permit achievement of the 35/33 percent top rates and related objectives while strengthening the Federal tax system. To make this statement easier to digest, sections are numbered and entitled from here on.

1. **The flat rate concept.** Unless the base of the personal tax were to be drastically narrowed, a single, flat rate of tax would crucify the lower and middle ranges of the middle incomes. The proposed 15/25/35 rate schedule, a spinoff from the flat rate concept, is neither the fairest nor the most rational way for achieving the 35 percent top rate. Increasing the beginning rate of 11 to 15 percent, followed by two 10-percent rate jumps, would aggravate the "hurdle" problem inherent in any progressive rate system. Adding a fourth rate higher than 35 percent would shortchange the economic benefit from rate re-structuring without resolving the hurdle problem.

2. **A good tax system.** A venerable axiom of tax policy thinkers is that there is no such thing as a good tax but there can be a good tax system if immoderate rates of tax are avoided by using all available tax methods.

3. **A tax on net income.** The point avoided by those who describe the personal income tax as being full of loopholes, breaks and preferences is that from its beginning the tax was intended to be just what it is -- a tax levied on net income. Major deductions such as but not limited to state and local taxes, interest, religious and charitable contributions, medical expenses and casualty losses, and exclusions such as employee benefits and life insurance buildup, are just as inherent in the system as are personal exemptions. Through the years there have been advocates of transforming the tax into one levied on gross income but this has never caught on. By further substantial narrowing of the base of the tax at the bottom, the program before you would limit the erosion of the "net income" concept to provisions of the greatest importance to the middle incomes.

4. **Excessive dependence on income taxation.** The Federal tax system is not a good tax system because of excessive dependence on the income taxes. Use of immoderate rates, not just at the top but through the broad range of the middle incomes, has characterized the personal tax through most years of its existence. The rates of tax on corporate income have been beyond the realm of economic reason since World War II. These problems can not be resolved by reshuffling tax burdens either within the separate income tax systems

or between the two. Corporate income (profits) is the most uncertain, unpredictable and variable as between companies and business groups of all economic factors and, hence, is the most unreliable source of tax revenues. Enacting top rates of 35/33 percent should not be dependent on getting more revenue from this source.

The emphasis on corporations as taxpayers has inhibited Federal policy recognition of the role in tax collecting which can only be performed by corporations and unincorporated businesses. There is no more reliable source of revenue.

5. **Base broadening.** For more than three decades tax scholars have faced the problems of excessive dependence on income taxation and the unreliability of the corporate tax and have consistently come up with the conclusion that a value added tax, or VAT, is the only solution. A frustrating reality, however, has been that a VAT probably would not be enacted until Federal policy leadership becomes committed to results which could not otherwise be brought about.

There seems little doubt that, perhaps given a little more time, a VAT will be enacted as an add-on to spending reductions to reinforce the bi-partisen commitment for getting the deficit under control. The Presidential commitment to bringing the top tax rates down to 35 and 33 percent seems equally strong. The combination of top rate moderation and deficit control could herald an era of strong economic growth which otherwise may be unattainable. The base broadening reform of a VAT is the turnkey to it all.

6. **What kind of a VAT?** Here is the challenge. Maximum base means a minimum rate. Without base-eroding provisions, a flat rate VAT will raise from $25 billion upward for each percent of tax. It may be hoped that all of those who have advocated or have been drawn into support of the idea of broadening the base of the personal income tax will transfer their interests and energies to enacting a maximum base VAT. The income tax started out on the wrong foot insofar as a broad base is concerned. If we do not get off on the right foot with a VAT, who knows what new base-eroding provisions and related complications would be added through the years.

7. **The regressivity bugaboo.** Scholars who so clearly have seen the national need for a VAT too often have become little more than apologists for the concept when the charge of regressive is made. Instead of confronting the charge, they pull the rug on the main purpose of a VAT by proposing all sorts of base-eroding provisions designed to alleviate the impact on the lower incomes.

Once upon a time taxes were thought of as being either progressive or proportional; a tax with increasing rates on a common base was progressive and one with a single rate on a common base was proportional. A century or so ago, the Scottish economist, McCulloch, commented that when the priciple of proportional taxation is abandoned in favor of progression, you are at sea without rudder or compass. Sometime, somewhere through the years someone came up with the notion that the base for determining the incidence of any and all taxes should be personal income. Thus, ipso facto, a proportional tax, on income or on any other base, became a regressive tax.

Applied to an entire tax system, such a creed would fulfill the Socialist dream of taking in proportion to ability and giving in proportion to need. Universally applied at all levels of government in a nation like ours, there would develop an ever-growing underclass of people with no responsibility for their own welfare. Imagine, for example, providing credits below given income levels for taxes on specific goods and services such as soft drinks, not-so-hard and hard drinks, tobacco products, horse racing, lotteries and for the pass-through incidence of taxes on business property, business income and services such as rentals. There would be no more reason to exempt specific items, such as food and drugs, from a VAT than there would be to exempt the producers and distributors of such items from the income tax.

The high beginning rates of the personal income tax make it necessary to forego extraction of this tax from a great many of our citizens. By raising the bottom rate from 11 to 15 percent, this situation would be aggravated under the Administration's program.

As a general policy, however, it must be agreed that tax absolution is an inefficient welfare instrument.

We are morally obligated to help those who find it impossible to help themselves either permanently or temporarily. In doing this through the expenditure route, we can exercise control in distinguishing between the indigent and the indolent. The great continuing difference between many people in the lower and in the middle income levels is making the effort. It would be much, much better to make adjustments in welfare payments to reflect the higher incidence of indirect taxation than it would be to fail to realize the full potential of a VAT free of any base-eroding provisions. The burden would be diffused throughout all income levels instead of being disproportionately concentrated on middle incomes which happen when traditional deductions and exclusions are repealed or modified.

**8. Tax rates and the middle incomes.** Two factors aggravate the inevitable heavy burden of income tax borne by the middle incomes. One is the top rate. The other is the point in the income scale at which the top rate cuts in.

The higher the top rate, the higher will be the rates through the middle incomes building up to the top rate. Other things being equal, therefore, the lower the top rate the lower will be the rates through the middle incomes. But, as is so evident in the Kemp proposal for a flat rate tax, this can be carried too far. There is no way to narrow the base of the tax at the bottom and consolidate all other rates into a single rate which will not result in a very substantial relative increase of burden in the lower to middle ranges of the middle incomes. The 35 percent top rate proposed by the Administration lessens the problem but does not entirely resolve it. This is where the other factor comes into play.

Speaking illustratively, if the top rate did not cut in below a million dollars, both the average and the buildup of rates through the middle brackets could be very modest. We

do not live in such a happy time. We can be concerned only with moderation. I urge your consideration of a principle that the top rate of income tax should not cut in until the threshold of the high income level is reached. Considering that before the great inflation of the contemporary era a $50,000 income for a family was not thought of as high, the threshold for the family today would be at least $200,000. For singles, it would be half of that.

**9. Tax fairness for the married.** There was only one rate schedule until 1948. That year, on the initiative of this Committee, the split income provision for married couples was enacted. Each spouse paid tax on one-half of family income, using the existing schedule. A new schedule was added for heads-of-households.

The split income provision recognized that marriage is a partnership and that the contribution to the partnership is not determined by whether one or both spouses earn income or how much each earns. This was the ultimate recognition of the homemaking wife's contribution to a marriage.

In 1969, the split income provision was emasculated. The question is how could it have happened? I suspect that there are not too many around today who know the answer.

As long as the law was administered as enacted, there was little or no public criticism or complaints about it. Who would have dared? However, on what authority I have never known, the Revenue Service in the 1950s began using a separate rate schedule for marrieds incorporating therein the results of income splitting. The rate schedule formerly used by all taxpayers except heads-of households was redesigned as applying only to singles. This created a "perception" of discrimination against singles.

Resentments began to surface and flourish. A businesswoman, who through the years had waged a vigorous fight against income tax withholding, became the most outspoken and conspicuous of the claimants of discrimination against single taxpayers. Whatever the weight of her influence compared with that of others, the Ways and Means Committee

in 1969 initiated a substantial reduction in the rates paid by single taxpavers.

In 1969, openly living together without benefit of marriage was not yet conventional. In a few years, however, the fact that two singles living together faired much better tax-wise than two-earner marriages resulted in some married couples divorcing at the end of one tax year and remarrying at the beginning of the next. To thwart an initiative in the Congress to cope with the situation, the Reagan Adminsitration in 1981 proposed the partial relief for two-earner marriages which was enacted into law.

The 1981 action was and is a blatant discrimination against marriages in which one partner is a homemaker. Only a return to income splitting will provide tax equality between all married couples and between two-earner marriages and two singles living together. Income splitting is the ultimate "pro-family" provision.

**10. Capital Gains.** This Committee provided the leadership in 1978 for increasing the exclusion for longterm capital gains from 50 to 60 percent. As evidenced by Treasury I and other developments, perennial tax reformers persist in the view born in the doom-and gloom of the great depression that capital gains are income. They are aided and abetted by the continued inclusion of capital gains in the list of preferences under the minimum income tax. Their rhetoric centers on the gains realized by the rich and, by implication, dismisses the importance of gains to many people through all ranges of the middle incomes and sometimes to people in the lower incomes. Worst of all, in their obsession with the view that gains are income, they blind themselves to the economic harm done by transforming capital into government spending.

In a statement presented in the Ways and Means Committee's hearing on July 31st, I explore the source of the tax reformer's addiction to taxing gains as income and, I believe, successfully discredit it. Entitled "Perspective on Taxing Capital Gains", with some revision the statement is attached as Appendix A. The conclusion is that the economic benefits from enacting top tax rates of 35 percent on personal income and 33 percent on corporate income would be substantially enhanced by increasing the exclusion from 60 to at least 70 percent and by removing gains from the minimum income tax.

**11. Ending a grossly wrong tax.** For reasons set forth in my writing under this title, attached as **Appendix B**, the tax on Social Security benefits enacted in 1983 under conditions of extreme stress and without adequate exposure to public analysis and discussion should be repealed without further delay. In some cases, taxpayers without taxable income are liable for tax on one-half of their benefits.

**12. Financing Social Security COLAs.** Social Security is an inter-generational program but financing COLAs for whatever Federal programs is totally an intra-generational matter. No matter how unintended inflation may be, only the government through acts of commission or omission causes it and only the government can end it. Like all other Federal COLAs, therefore, those for Social Security benefits should be financed out of the general revenue and not by charges against the Trust Fund.

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## PERSPECTIVE ON TAXING CAPITAL GAINS

A Statement by
John C. Davidson
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It has been a long time coming, but finally there is a national consensus on our nation's problem of under-saving. Undersaving and under-accumulation of capital are the same thing. The nation's stock of capital is not growing fast enough to underwrite optimum conditions of economic growth, productivity and job creation. In their deliberations, the tax writing committees face the question of the economic nature of capital gains. I urge it be recognized that gains are part of capital. This means that any taxation of gains is in fact a tax on capital. The taxation converts capital into government spending.

Since 1969, tax law has labelled capital gains as being income. This labelling has not been withdrawn despite the economic wisdom displayed by the Congress in 1978 when it increased the exclusion from 50 to 60 percent. The labelling is the designation of capital gains as a preference under the minimum income tax. Intended or not, this amounts to legislative validation of the claim that capital gains are income; a claim which lacks any substantive support. One result is a license for high income bashing on the percent of income taken in income taxation. Including gains as income significantly lowers the percent and misinforms the media and the public as to effective rates of tax on real income up the income scale.

Why did it happen in 1969 and why has not the dialogue on taxing capital gains broken away from such inaccurate and unfair labelling? The answer does not seem to have been openly discussed in legislative hearings and floor debates. It largely reflects long-ago thinking of just one professional as undated and energized by another.

The first, the late Henry Simon, distinguished Professor of Economics at the University of Chicago, lectured in the 1930s that capital gains are part of income and should be taxed as such. Perhaps not too consciously, the Professor like many if not most economists in the doom-and-gloom of the Great Depression was caught up in the belief that the Depression resulted and persisted from over-saving and under-spending--just as Fabian Socialists had prophesied in the 19th Century.

The over-saving complex hung on in liberal economic thinking for decades after the 1930s. But it remained for the second professional, now deceased Stanley Surrey, Law Professor and Assistant Secretary of the Treasury during the Kennedy and Johnson Administrations, to install the Simon dictum as the linchpin of the tax reform movement. In his 1959 paper, "Definitional Problems in Capital Gains Taxation," which became basic to the movement, he simply accepted what Professor Simon had said as though it wes incontrovertible in any period. The movement achieved the first step toward its goal in the 1969 enactment of the minimum income tax with capital gains listed as a preference.

I was well acquainted with Professor Surrey during his work in Washington. He would not engage in in-depth discussion on the economic impact of tax proposals and policies, always deferring to answers provided by economists in his orbit. And, on the nature of capital gains, the economists always relied on what Professor Simon had said even then so long ago.

It would be harsh judgement to believe that, if the distinguished economist had lived into these times, he would still say that capital gains are a form of income and should be taxed as such. Having no doubt that the esteem in which he was held by his colleagues and students was warranted, I believe he would now reject the doctrine of over-saving. He surely would be in the vanguard of those urging that greater saving and investing is critical to realizing the optimum economic conditions we all want.

There are some who will continue to resist seeing the connection between national under-saving and the labelling and taxing of capital gains as income. The phrase "capital income," contrived to say something which just is not so, serves to encourage the resistance. The connection is unavoidable, however, when we start with the buyer instead of the seller of an asset.

If the accumulated capital of A, a prospective buyer, were subjected to a capital levy, the amount taken obviously would be a subtraction from the nation's capital supply. While we shudder at the thought of such a tax in America, we have one disguised as a tax on income. When A uses his capital to buy an asset from B, it is the same capital which then becomes subject to the gains tax. The tax in reality is a capital levy measured by the gains. The subtraction from the nation's capital supply is the same whatever the name given the tax.

The tax writing committees are considering enactment of top tax rates of 35 percent on personal income and of 33 percent on corporate income. Carefully crafted, such rates inevitably will enrich the spirit as well as the substance of economic go-power. Both would be substantially enhanced by increasing the capital gains exclusion from 60 to at least 70 percent and by removing gains from the minimum income tax. Best of all but perhaps not for now would be the end of anything more than nominal transfer taxation of capital gains.

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## ENDING A GROSSLY WRONG TAX

In the June 27th "Washington Post", House Speaker Thomas P. O'Neill was reported to have suggested increasing the base for taxing Social Security benefits from 50 percent to 85 percent of the affected taxpayers' total benefits.

This report seems to confirm what sources have stated, namely, it was the Speaker's insistence which got the tax enacted in 1983. At the time experts were claiming that either benefits had to be reduced or revenues increased to keep the system solvent. The innovative feature of the tax was that the proceeds would go directly into the Social Security system instead of into the general revenues of the government. Before the end of 1984, however, it had become evident that the advice causing the enactment had been just plain wrong--the system was not faced with insolvency. Presumeably in recognition of this fact, the Speaker's June concern was in increasing the flow of the System's surplus into financing the general budget deficit.

There could be no doubt that it was with the greatest reluctance even excruciating pain that most members of the Congress voted to tax a segment of Social Security benefits. Even so, there also could be no doubt that few if any of the members had any inkling of how grossly discriminatory and wrong the enactment was. The record discloses no objective analysis of how the tax would work. If such an analysis had been available, it would be safe to say that the tax never would have become law. Since the Social Security system does not in fact need the revenue to ward off insolvency, there is no case whatsoever for continuing the tax.

Most of the millions of taxpayers immediately and prospectively affected by the tax did not realize what they were in for until this year when 1984 tax returns and 1985 estimates of tax became due. The first political test of the tax therefore could not come until the 1986 Congresstonal elections. If the tax is to be repealed, the best time to do it is quickly so that the affected can reduce their estimated tax payments and begin to wind down from their smoldering rage.

The question was not and is not whether Social Security benefits should be taxed like other pensions. That is not what was done in 1983. The pros and cons on this issue do not seem to have been examined in any depth. Even if such an examination should lead to agreement that the benefits should be taxed, the 1983 enactment would serve only as an example of what to avoid. The Speaker does not seem to understand that the tax was totally wrong and unacceptable even when perpetrated in confronting a perceived emergency. The tax was wrong not just because the estimates of pressing need were wrong. Even if those estimates had been right, the enactment was wrong without any redeeming feature.

Social Security is an inter-generational transfer system. The principle of working people earning rights to related future benefits makes it a pension system which is under the dominion of government, but not part of regular government operations. It is in contrast with other national pension systems essentially based on state largesse.

The 1983 tax undermines the foundation of our system. It is not a tax in the normal sense, but is a device for benefit redistribution within the system abrogating earned and established rights of the affected beneficiaries. Contrary to the principle on which Social Security was founded, the exaction is an intra-generational transfer of benefits rights--a taking from a minority of beneficiaries to bolster the payment of benefits to the majority.

Seemingly to avoid immediate public understanding and controversy, the tax was wrongly and deceptively labelled as applying only to the "higher incomes". Actually, the exaction takes hold in the transitional zone between the lower and middle incomes. The great burden falls on the lower range of middle income beneficiaries.

The tax is wrong because it introduces a "needs", "means" or "welfare" concept in redistributing benefits based on earned rights. It is absurbly wrong in casting beneficiaries in the upper ranges of the lower incomes in a "disadvantaged" role. It is wrong to establish a double standard for taxing different kinds of pensions. All but Social Security are taxed where taxable income begins after prevailing exemptions and deductions.

Other pensions and other forms of income are protected from tax by exemptions and deductions which reduce adjusted gross income to taxable income. The tax on benefits is wrong because it denies this protection to the affected--a denial even more devastating in cases than a hardcore tax reformer's fondest dream. Specifically, one-half of the benefits of marrieds are taxed if and to the extent their adjusted gross incomes plus one-half of their benefits exceeds $32,000. This means that, in some cases involving illness, business losses and casualties, the affected will have zero taxable income, but will be liable for tax on one-half of their benefits. A good guess would be that considerably more than half of the affected beneficiaries will have taxable incomes ranging from $18,000 down to $12,000 or less. This accentuates the deception in labelling the tax as applying only to the higher incomes.

The tax is wrong because it provides a substantial inducement for living together without marriage and for tax-saving divorces. One-half of the benefits of singles are taxed if and to the extent their adjusted gross incomes plus one-half of benefits exceed $25,000. This means that with equal AGIs and taxable benefits of $4,000 each, two singles living together would not be fully taxed on the benefits until the aggregate reaches $58,000. A married couple with $8,000 in taxable benefits would be fully taxed on the benefits when their aggregate reaches $40,000.

The tax is wrong because it results in double taxation when a Social Security beneficiary on the threshold of Social Security tax liability receives additional income from another source. As examples, the income could be earnings from part time work or interest or dividends from an inheritance or gift. Until one or the other runs out, each dollar of tax on the income is matched by a dollar of tax on the benefits.

The abrupt effectuation of the full burden of the tax was wrong because it departs from the honored rule that any such change become effective only prospectively and gradually. Imagine a similar dishonoring of the rule with respect to ending Federal pensions at 55 without actuarial reduction.

It is a tax without a single virtue or any justification. Neither amendment nor revision could rectify the inherent wrongness of the enactment. It should have been repealed effective January 1, 1984. Its repeal should now take place effective January 1, 1985.

Revised October 1, 1985

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ASSOCIATION OF FLIGHT ATTENDANTS STATEMENT ON
ADMINISTRATION'S TAX REFORM PROPOSALS

The Association of Flight Attendants, AFL-CIO, representing 21,000 middle income flight attendants in the airline industry, endorses some of the Administration's proposals which promote equity and progressivity in the tax structure for working people. For example, raising the personal exemption and increasing the zero bracket amount will rightly lift the tax burden from many in poverty.

We strongly object to other proposals, however, which, by the Administration's own calculations, will shift more of the tax burden onto middle income workers -- such as flight attendants, while reducing the tax burden for the most wealthy. Specifically we oppose the following proposals:

- eliminating the second-earner deduction
- changing childcare credit to a deduction
- instituting a tax on employer-provided health insurance
- instituting a tax on worker compensation
- instituting a tax on unemployment benefits
- eliminating deduction for state and local taxes paid
- imposing an additional tax on early distributions from retirement plans

- repealing the 10-year averaging of lump-sum distributions from retirement plans

- eliminating the special recovery rules for qualified plan distributions

Each of these issues will be discussed in turn.

Second-Earner Deduction and Child Care Credit

Despite the President's description of his proposals as "the strongest pro family initiative in postwar history", several of the proposed reforms penalize working families and ignore the fact that the number of "traditional" families with working husband and non-working wife is now equalled by single parent families, and is outnumbered by two-earner families two-to-one.

The predominately female flight attendant population reflects this national trend: more than 60% of our flight attendant members are married, and more than 40% have children. Flight attendants are middle-income Americans who work hard because of economic necessity to support themselves and their families; they must make private arrangements for child care since their airline employers do not provide it as a benefit.

The Administration's reforms penalize working families by 1) eliminating the second-earner (marital) deduction and 2) changing the current dependent care tax credit into a deduction.

The marital deduction was instituted only three years ago as a step towards tax equity for working couples who suffered a "marriage penalty" for filing together, particularly those of moderate income where both spouses earned about the same salary.

The marriage penalty resulted from a working couple's greater share of nondeductible employment-related expenses than a one-earner couple, and from the lower zero bracket amount for a married couple than for two single taxpayers.

The Administration would reinstate this marriage penalty by eliminating the second-earner deduction which currently reduces the inequitable impact toward married couples of the proposed zero bracket amounts.

Changing the tax treatment of child care expenses from a credit to a deduction is particularly regressive. Current law recognizes that the greatest benefit should be provided to low-income people. Thus under current regulations, a sliding scale allows a maximum credit of 30% of expenses up to $2400 for one child (or $720) for an adjusted gross income of $10,000 or less, declining to 20% (or $480) for those with an adjusted gross income greater than $28,000.

By contrast, the proposed change from a credit to a deduction would provide the greatest benefit to those in higher income brackets. This would occur for two reasons: for non-itemizers who tend to fall at the lowest income levels, it will be more difficult to use the deduction, and the deduction

will be worth more to those itemizers at higher income levels. The Administration is proposing that married couples with taxable incomes between $4,000 - $29,000 would receive a 15% deduction while those above $70,000 would receive a 35% deduction.

In human terms, this means that a flight attendant head of household earning a gross income of $20,000 who has one child in day care, who rents her home and thus does not itemize her tax return - will not benefit at all from the child care deduction. She will lose the entire $600 credit now available to her.

On the other hand, a working couple with gross income of $65,000, who has one child in day care, would receive a deduction worth $600.

This proposal can hardly promote fairness when the low income non-itemizer receives no benefit while the highest income family receives the greatest benefit. The Administration admits that the proposed deduction "is relatively less favorable to low-income families than is the current credit." We are offended by the Administration's rationale for the proposed change: that dependent care expenses should be treated as any other business expense. Child care costs borne by working parents are different from business lunch expenses. Child care expenses are shouldered by young dual-earner families and single parents who must purchase private child care services in order to work because the U.S. lacks a coordinated government-sponsored day care system.

For lower-income working couples who would derive little or no benefit from the child care deduction, loss of the current child care credit would create a disincentive for the lower-earning spouse to work.

The tax code should reflect a national social policy which supports working families and their children. The dependent care credit was a step in the right direction -- changing the credit to a deduction would be a serious step backwards.

Employee Health Insurance

We strongly oppose the Administration's continuing attempt to impose a tax on employee health insurance benefits. The current proposal to tax the first $25/mo. employer-paid premiums for family coverage or $10/mo. for individual coverage is just as onerous as the earlier Treasury proposal to tax employer-provided health premiums above a monthly cap.

This proposed tax on employee health benefits would be regressive -- impacting most heavily on lower wage earners for whom the additional $300 per family or $120 per individual comprises a larger portion of total annual income. By the Administration's own estimates, employer contributions represent 19% of income for workers making less than $10,000 compared to only 14% of income for those making $200,000 or more. In addition, 60% of the additional tax liability from this proposal would be borne by families with incomes below $50,000, while only

6% would be shouldered by families with incomes of $100,000 or above.

The Administration may view the $300/$120 annual floor to pose a negligible tax burden. If the proposal were to become law, however, it would sanction employee health insurance as a tax target and would invite future tax reformers to raise the floor or remove it altogether whenever more tax receipts were needed.

In examining these benefits Congress is not dealing with frivolous "perks" or gimmicks to shelter income, generate phony losses or otherwise reduce the taxes of a privileged few. These measures are for the most part long-standing economic buttresses of the tax code, that affect millions of workers and are widely distributed.

Taxing health insurance premiums would result in several negative consequences.

First, families that cannot afford the new tax on health insurance coverage may opt out of employer plans and be forced to seek inferior coverage in an individual policy. This would result in increased premiums for those who remain in the plan.

Over the past several years employers have, through increased deductibles and co-payments, transferred increasing health care costs to their employees. Compounding this burden with more taxation will cause a significant portion of the population to drop insurance coverage. Because insurance

succeeds on economies of scale through large "group" plans, employee benefit plans would "starve to death" within a few years, and the cost to the remaining pool of those covered would be driven sky high.

Of those remaining, many would be older workers who tend to use the benefits more. The costs to them will be prohibitive. The Administration fails to take into account that many of our senior citizens have continued medical coverage provided by their prior employer as a retirement benefit. The proposal would unfairly shift the tax burden towards these older people.

Second, a tax on health benefits will have a disproportionate impact on certain urban areas and geographical regions where medical costs are especially high. Workers in high cost areas may reach their cap on the same level of benefits before workers in low cost areas.

Taxing health insurance premiums is a poor mechanism to generate tax revenue, and could actually result in increased government spending to fill the gaps left by weakened private benefit plans.

* Every time the government needed revenue, this floor would be raised.

* As employees opt out of employer programs to avoid paying taxes, less taxes will be collected.

* The level of health benefits will decrease as tax preferences for health plans are eliminated or reduced.

* Pressure will mount for government to expand existing benefit programs or establish new programs to fill the gap left by weakened private programs. The cost of new or expanded government programs would ultimately overshadow the revenue foregone under the current tax rules for employee benefits.

Finally, this proposal ignores the fact that employers are allowed a business deduction for providing these benefits. Apparently the Administration rightly feels that to reduce the incentive to provide these benefits by an action such as reducing the corporate deduction, would have a negative impact on the corporations as well as the health of the population as a whole. But it does not consider the negative impact visited upon the individual taxpayer to be very significant. This is fairness?

Unemployment Compensation, Workers' Compensation

We strongly object to the Administration's proposals to make unemployment compensation fully subject to taxation, and to repeal the present tax exemption on worker's compensation.

Unemployment insurance benefits provide essential income to workers who continue to suffer severe job and income loss. Above certain thresholds, such benefits are already taxed, adding to the hardship of being unemployed and diminishing the program's intended use as an economic stabilizer. The suffering of

unemployed workers should not be compounded by increased taxation of their unemployment benefits.

Due to the lingering effects of deregulation of the airline industry, many airline employees have been laid off over recent years. Renewed fare wars, grounded aircraft, or another recession may quickly place many flight attendants and other airline employees on the unemployment rolls again.

Workers' compensation benefits are already inadequate to meet the needs of disabled workers and their families. In most states the benefit level is only sixty-six and 2/3 percent (66 2/3%) of the average weekly salary. Taxation of these benefits would widen the gap between payment levels and income levels required to maintain decent living standards. It would not be fair to add to the burden of injured workers that need these payments.

State/Local Tax Deduction

We oppose the proposed elimination of the long-established deduction for state and local taxes. For homeowners, who tend to itemize, this proposal would obviate the combined effects of the increased zero bracket, higher personal exemption and flatter tax brackets, and result in a higher - not lower - tax bill. For example, under the proposals, married homeowners earning $55,000 gross income who pay average state and local taxes of 6% will pay an additional $825 more in taxes because of the elimination of

this deduction. A similar couple earning $45,000 would pay an additional $675.

Their net tax bills will be higher than under current law by $513 (9.1%) and $274 (6.6%) respectively, despite the mitigating effect of some of the progressive proposals. For those living in high-tax states, such as California and New York, the impact would be even more severe.

Contrary to Administration arguments, the current deduction for state and local taxes benefits a majority of married couples, including more than 3 out of 4 median income families, according to IRS figures.

The Administration argues that taxpayers who are burdened by the elimination of this deduction can choose lower state and local taxes through the electoral process or through relocating to lower tax areas. The long term result would be weakening of the state and local tax base. This translates into cutbacks in public services: education, fire and police protection, aid to dependent children, Medicaid, highway repair, etc. Consider the cruel ironies of this proposal:

* it would most hurt states which have higher levels of taxation and spending due to their higher level of public responsibility, and/or their disadvantaged populations which require more public services.

* it would penalize state and local governments for providing high levels of public services at the same

time the Administration has been trying to shift responsibility for public service from the Federal to the state and local level.

* it would erode state and local tax bases at a time when state and local governments are facing growing fiscal strains due to recent curtailment of many Federal aid programs coupled with the increasing needs of a growing elderly population and a mini-baby boom.

The impact of this proposal can hardly promote "fairness". To suggest that the alternative to a higher Federal tax should be cutbacks in essential state and community services reflects callousness and inconsistency on the part of an Administration which had appeared to foster federalism.

Pensions

In the area of pensions, the Administration proposes several significant changes to which we object. We will treat each of these issues separately.

First, the proposal would impose a 20% tax on the taxable portion of most distributions made from a tax favored retirement plan prior to the participant's death, disability, or attainment of age 59½.

Many retirement plans offer early retirement before age 59½ - often at age 55. These programs recognize both the changing nature of the workforce as well as the economic

environment. In addition, many plans allow for early retirement at age 50 with 10 years of service. Many companies also offer special bonus programs, "$15,000 Early Out Benefit" for anyone with five years of service for example. The advantage of such bonus programs, to the companies is "reduced labor costs."

Due to economic realities in the airline industry, employers have pressed for -- and we have sometimes agreed to -- "early out" programs where more senior workers are encouraged to leave the workforce. In some cases, the resulting cost savings may have made the difference between an airline's bankruptcy and continuing operations. Senior employees think long and hard before choosing an "early out," or an early retirement. An additional tax on the benefit might discourage employees from using these programs.

The Administration clearly failed to consider the impact its proposed tax would have upon benefits for the many employees who are covered by such early retirement programs, and upon those who choose early retirement thus allowing younger workers to remain employed. They also failed to recognize that most early retirement benefits have been subject to an actuarial reduction.

Second, the tax reform proposals would also repeal the 10 year averaging of lump sum distributions as well as eliminate the special recovery rules for qualified plan distributions. The three-year recovery rules were originally designed so that any portion of a pensioners' retirement benefit that is attributable to his or her contribution would be received tax free. This is

because her contribution, when made to the plan, was made with after-tax dollars. To repeal these rules results in double taxation.

The 10 year averaging rules were designed to spread taxable income from a lump sum distribution over a period of time. This softens the prohibitive tax burden which would otherwise be impose upon many senior citizens who are on a fixed income. It also protects many workers whose plans terminate and also those whose retirement benefit is so small that it is more economical to them to receive a lump sum.

These rules were designed to help the pensioner in the first few years of retirement which traditionally are the most financially and emotionally unsettling. To eliminate these distribution rules only buries the pensioner in a deeper hole with inflation being the ever constant shovel.

Another problem with the proposal is that it fails to recognize that pension plans, as well as other employee benefit plans, are already subject to stringent rules imposed by the IRS and ERISA which must be met in order to qualify for tax favored status. These rules are designed specifically to prevent discrimination and promote equity in the retirement savings arena.

One final point must be raised. The Employee Benefit Research Institute has concluded that pension funds now constitute 29% of the publicly traded equities in America, affect the financial security of 75 million Americans and thus fuel

growth and job creation in all segments of the economy. To impose more rules and administrative burdens may deter many employers from continuing these programs altogether, would hurt capital markets and hinder formation of capital, much to the detriment of the nation as a whole.

The Administration's plan hardly promotes fairness for working people when, by its own calculations, it shifts the individual tax burden onto middle income families while reducing the tax burden for those earning $200,000 or more. The proposals will, in fact, result in a higher tax bill for many middle-income flight attendants, according to our estimates (See appendix). This statement discusses specific proposals which are regressive and which would in many cases, offset some of the plan's progressive features such as the increased personal exemption and increased zero bracket.

We urge Congress to fashion a truly progressive package which will ensure that corporations and high income individuals pay their fair share of revenues. Tax reform for the sake of "simplicity" cannot promote "fairness" if it is achieved at the expense of low and middle income workers.

- Appendix -

Estimated Impact of Administration's Tax Reform
Proposals on Flight Attendant with Gross Income of $25,000

| Gross Income Flight Attendant | Spouse | Filing Status | Itemizer | Exemptions | Child In Day Care | Net Change in Tax Due $ | % |
|---|---|---|---|---|---|---|---|
| $25,000 | $ N/A | Single | No | 1 | N/A | $ -514 | - 13% |
| " | " | " | Yes | 1 | " | - 44 | - 2 |
| " | " | Head of Household | No | 2 | 1 | -250 | - 9 |
| " | " | " | Yes | 2 | 0 | - 1 | -0.1 |
| " | " | " | " | 2 | 1 | +166 | + 11 |
| " | 20,000 | Joint | " | 2 | N/A | +274 | + 7 |
| " | " | " | " | 3 | 0 | + 47 | + 1 |
| " | " | " | " | 3 | 1 | + 81 | + 2 |
| " | 30,000 | " | " | 2 | 0 | +513 | + 9 |
| " | " | " | " | 3 | 0 | +318 | + 6 |
| " | " | " | " | 3 | 1 | +198 | + 4 |

Assumptions:

Itemizer's First Mortgage Interest: 13% x 1.8 x gross income
IRA Contributions: $1000 (single), $500 (head of household,
$1000 ($25,000/20,000 gross income couple),
$2000 ($25,000/30,000 gross income couple)
Charity Contribution: 2% x gross income except 1% gross income for single
Child Care: filer currently takes maximum allowable credit, and will take maximum allowable deduction under proposals
State Tax Rate: 6%

STATEMENT OF HON. BILL BONER (D-TN)

BEFORE THE SENATE FINANCE COMMITTEE

IN SUPPORT OF SECTION 190 OF THE INTERNAL REVENUE CODE

PROVIDING A DEDUCTION FOR THE REMOVAL OF ARCHITECTURAL BARRIERS

TO THE DISABLED AND ELDERLY

OCTOBER 1985

Mr. Chairman and Members of the Committee:

I would like to thank Chairman Packwood and the Members of the Finance Committee for giving me this opportunity to present a statement in support of retaining the deduction for the removal of architectural barriers to the disabled and elderly.

This deduction, known as Section 190 of the Internal Revenue Code, allows businesses to receive up to a $35,000 deduction for removing architectural barriers and making their places of business accessible to the disabled and elderly. Under current law, the deduction is scheduled to expire at the end of this year and the President, in his tax reform package, has recommended that it not be renewed.

While I share the view that the tax code should be fairer and less complex, I also believe that the code can and should be used to encourage activities that would not otherwise be undertaken. I believe that one of these activities is improving accessibility for the disabled and elderly to places of business, commerce, and employment. This goal is consistent with the policies toward citizens with disabilities enacted by Congress over the past 20 years.

Between 1968 and the present, the Congress has passed several laws aimed at enhancing the quality of life for elderly and disabled Americans. The centerpiece of these efforts was the enactment of the Rehabilitation Act of 1973, which in essence afforded these individuals greater protections and opportunities.

Underlying the Rehabilitation Act and other laws assisting the disabled and elderly is the concept of access - access to education, to employment, to public facilities and services, to transportation, to housing, and to other resources needed by disabled and elderly Americans to realize more fully their rights as citizens and their potential as individuals. Architectural barriers are obstacles that limit opportunity, restrict choice, frustrate self-help and, in many ways, promote discrimination and ignorance of the disabled and elderly.

The effort to remove barriers in the physical environment is a relatively recent one. The focus at the national level can be dated back to the 1958 President's Commission on Employment of the Handicapped. In 1961, the American National Standards Institute (ANSI) issued standards and minimum requirements for structures such as walkways, parking spaces, ramps, floor surfaces, stairs, mirrors, water fountains, public telephones, control identifications, and warning signals.

These ANSI standards generated considerable interest in the architectural barriers problem, although compliance with them was completely voluntary. Not until 1968, with the passage of the Architectural Barriers Act, did the federal government begin efforts to ensure that certain public buildings be designed and constructed so as to be accessible to the physically disabled.

Within the private business sector, market or economic forces alone will not remove these barriers. Without incentives such as the one provided by the Section 190 deduction, businesses

are reluctant to incur the expenses necessary to make their buildings accessible. Because the great majority of our nation's population have little, if any, difficulty gaining access to offices and other buildings, businesses have little incentive to accommodate the disabled and elderly. This realization led Senator Bob Dole and other Members of Congress to work to enact as part of the Tax Reform Act of 1976 a deduction for the removal of architectural barriers. Since that time, Senator Dole and other Members, including myself, have worked to renew and extend this deduction.

Members of this Committee are well aware that improvements in medical science have increased the number of disabled and elderly persons in our society. In the case of older Americans, we have added years to life. But our nation has only just begun to pursue policies to add life to those years. Thus, when we deny access to places of employment and commerce, we deny the disabled and elderly the opportunity to lead full and independent lives. To achieve the goal of improved accessibility, I believe that a joint federal-private partnership is necessary and that Section 190 provides such a cost-effective partnership.

At minimum, I respectfully request the Committee to consider a longer extension of the Section 190 deduction than has been previously provided. In addition, I request the Committee include a reporting requirement so that Congress can evaluate the extent to which the deduction is used. I discovered last year

that the Internal Revenue Service does not have the ability to tell Congress how many businesses have used the deduction.

In closing, I would like to repeat my view that the assistance and incentives the federal government can encourage through the tax code can make the difference as to whether the disabled and elderly can find jobs suited to their talents and opportunities suited to their needs. Because Section 190 is the only fiscal inducement to private businesses to make their facilities accessible, I encourage the Committee to incorporate it into the tax reform measure that you soon will be drafting.

Thank you.

national easter seal society
OVER 60 YEARS OF SERVICE TO INDIVIDUALS WITH DISABILITIES

Office of Governmental Affairs

October 23, 1985

Honorable Bob Packwood, Chairman
Senate Finance Committee
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510

Attention: Ms. Betty Scott-Boom

Dear Mr. Chairman:

I am writing with regard to S. 887, to amend the Internal Revenue Code of 1954 to extend the deduction for expenses incurred in connection with the elimination of architectural and transportation barriers for the handicapped and elderly through 1989.

I respectfully request that this statement be included in the hearing record with respect to hearings that the committee has been holding on tax reform.

For over 65 years, the National Easter Seal Society has provided health and social services to children and adults with physical disabilities. Last year, Easter Seals served over a million people nationwide. The Society has focused its programs not only on the individual with a disability, but on the environment in which he or she must function. The National Easter Seal Society recognizes that the benefits received by disabled persons from our treatment centers are fully realized only when these persons are able to participate in the mainstream of life.

The Easter Seal Society has a long history of involvement with accessibility for people with disabilities. Many years ago, a grant from the Easter Seal Research Foundation to the University of Illinois resulted in development of design specifications for making buildings accessible. These specifications were approved by the American National Standards Institute in 1961 and became known as the ANSI Standards. Today, these specifications are referenced by building codes, laws and regulations at local, state and federal levels. The Easter Seal Society responds to questions from architects and designers on almost a daily basis.

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In its continuing advocacy role on behalf of the disabled, the National Easter Seal Society initiated a program, "Design for Accessibility", to help the business community understand the techniques for making buildings accessible to persons with disabilities. The program was conducted at conventions of more than fifty organizations during a two-year period. The program was undertaken under the sponsorship of private corporations.

Our experience in the area has convinced us that accessible designs are helpful not only to persons with disabilities. Accessible design is of benefit to all segments of the population, including the elderly, pregnant women, the very young in strollers, and those with temporary disabilities. Accessible design to accommodate everyone will allow persons with disabilities to participate in the mainstream with all segments of the population. The Easter Seal Society is being called upon more and more frequently by agencies serving the elderly to assist in insuring that older persons receive consideration in the field of accessibility. Several corporations have indicated that accessible accommodation could allow them to continue the employment of older persons. As the U.S. population continues to grow older, the need for providing accessibility in the workplace for the elderly as well as the disabled becomes more of a priority. A statement published by the Architectural and Transportation Barriers Compliance Board indicated that "by the year 2000, when World War II baby boom individuals become the senior boom, there will be one physically disabled person for every able-bodied one". While there are laws and regulations for accessibility, there continues to be a need for other incentives to provide a more humane environment, not just for persons with disabilities, but for all of the population.

The National Easter Seal Society was an early supporter of the tax deduction for the elimination of architectural and transportation barriers to the disabled and elderly. The Society was disappointed when the deduction failed to be extended and expired on December 31, 1982. Both National Society and its affiliates across the country actively supported reinstatement of the deduction and were pleased that the deduction was included in the Tax Reform Act of 1984. We appreciate the efforts of this Committee in that regard.

Tax considerations can often be an important factor in business decisions. Obviously, businesses will have a greater incentive to make their facilities accessible if they are permitted to deduct the expenses incurred in doing so in the tax year in which they are made. The deduction should be particularly helpful to small businesses that have limited resources to make this kind of capital expenditure. While the National Society supports S. 887, we would urge that the bill be amended to reflect language included in H.R. 1458 introduced by Congressman William H. Boner. Representative Boner has included a Reporting Requirement whereby the Secretary of the Treasury shall report to the Congress not later than January 1, 1991, the number of taxpayers taking the deduction, and the average amount of the deduc-

tion, provided by Section 190 of the Internal Revenue Code of 1954 for the most recent taxable year for which data are available. To date, it has been impossible to determine the number of businesses that have used the deduction. This new provision will enable Congress to assess the value of the deduction. The lack of such a reporting requirement has been a major weakness in the present provision.

The federal government has an important role to play in making our businesses and transportation facilities accessible. Congress demonstrated a commitment to the disabled and elderly when it adopted a Concurrent Resolution in 1975 that reads, in part, "Therefore, it shall be national policy to recognize the inherent right of all citizens to the full development of their economic, social and personal potential regardless of their physical disability through the free use of the man-made environment." Passage of S. 887 will be in keeping with that Congressional commitment.

Sincerely,

Roberta Van Beek
Assistant Director of
Governmental Affairs

RVB:cg



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Executive Office
(212) 686-6770
Member Chapter of Paralyzed Veterans of America

OCTOBER 23, 1985

# TESTIMONY TO THE U.S. SENATE FINANCE COMMITTEE

## CONCERNING S.887

Submitted by:
Terence J. Moakley
Barrier-Free Design Director

The Eastern Paralyzed Veterans Association is one of 33 chapters of the National Paralyzed Veterans of America. EPVA numbers approximately 2,000 members, most of whom reside in the four states of New York, New Jersey, Pennsylvania and Connecticut. All of EPVA members are disabled persons, either wheelchair users, or ambulatory with the assistance of canes or crutches.

The Eastern Paralyzed Veterans Association urges the Committee on Finance to report favorably concerning S.887. This bill would extend the $35,000 IRS Section 190 business tax deduction for barriers removal for a period of three years, and require that the IRS report the usage of Section 190 to the Congress at a future date. EPVA believes that many more businesses would use Section 190, if they knew about it. Further, we believe that given another extension of Section 190, this provision will be marketed by disability groups such as ours so that more businesses will use it.

In late 1984, EPVA began a campaign to market Section 190 to America's businesses. Attached to this testimony is a list of 41 periodicals which have chosen to print information about the existence of Section 190. Most of these 41 articles have been short "filler-type" articles, but several periodicals have chosen to print feature articles about Section 190.

As a result of this marketing effort, more than 2,000 of America's businesses have contacted EPVA, requesting information about IRS Section 190. To document this response, we are also attaching a list of the names and locations of businesses in our four primary states of New York, New Jersey, Pennsylvania and Connecticut which have contacted our association requesting Section 190 information. EPVA believes strongly that this overwhelming response proves that America's businesses are interested in Section 190, and would use it if it were renewed.

One of the very positive developments of EPVA's Section 190 marketing effort has been our ability to co-author several feature articles on Section 190 with Martin M. Shenkman, an accountant practicing with Townsend Rabinowitz Pantaleoni & Valente, P.C. in New York City. Mr. Shenkman is concluding a book entitled How to Do Tax Planning With Depreciation and the ITC, to be published in January, 1986 by Matthew Bender & Co., Inc. This book will have an entire chapter devoted to utilizing the Section 190 incentive. The book is part of the "Accountants Workbook Series", which will become a common reference manual in many accounting firms throughout the land. Reaching accountants with information about IRS Section 190 has become an important aspect of our effort to market Section 190. Mr. Shenkman's forthcoming book will be a tremendous help, but only if Section 190 is renewed. Mr. Shenkman believes that Section 190 is one of the few IRS provisions available to businesses which would not be abused as a tax shelter, since its main aim is better access to business for a deserving segment of our society. Because of the social good it leads to, it is an item not conducive to abuse as a tax shelter.

Beginning on October 11, 1985, EPVA has attempted to contact some of the businesses which have received Section 190 information from us. Eleven (11) of these responses are attached for the Committee's review. Six of the businesses which responded will use the Section 190 deduction.

South Nassau Dental Associates of Rockville Centre, New York reports using the Section 190 deduction in both 1984 and 1985 to improve ramps, bathroom and doors for handicapped persons at its place of business. National Underground Storage Inc. of Boyers, Pennsylvania also reports using Section 190 in taxable

years 1984 and 1985 for the installation of ramps and toilet partitions to improve accessibility for the disabled. Dr. Marvin J. Sagor of Delmar, New York will use the Section 190 deduction in 1985 for a ramp, widened doorway and an accessible restroom. Oneida Ltd. of Oneida, New York documents a Section 190 deduction in 1985 for replacing entrance steps with a ramp. Christine A. Browning of Milwaukee, Wisconsin is using the Section 190 deduction for the installation of a wheelchair lift in 1985. And, the Waukesha Foundry Company of Waukesha, Wisconsin informs us of using Section 190 in 1985 for improved accessibility to their plants. None of the above companies knew about Section 190, until they read about the information EPVA provides about it.

Five (5) additional companies responded to the EPVA questionnaire that they would use Section 190 if it is renewed for 1986. These businesses are Spectrum Office Products of Rochester, New York, Atlas Motor Inn of Cape May, New Jersey, L.O.P.C. of Richmond, Virginia, Quon Yee Restaurant of Forest Lake, Minnesota, and Penn Real Estate Company of Williamsport, Pennsylvania. EPVA believe that in the days and weeks ahead, we will receive more positive responses from businesses that have used Section 190, and would use it again if it were renewed.

The Eastern Paralyzed Veterans Association believes that more of America's businesses will use Section 190 if it is renewed by the passage of S.887. We believe that these written comments document both use of, and continuing interest in, Section 190. This provision of law is the only Federal incentive which exists for businesses to voluntarily remove barriers to the disabled. This is an extremely cost-effective approach to gradually eliminating physical barriers to disabled persons in America's businesses. For a change, it is the

business community, and not government, which is paying for needed accessibility changes for disabled Americans. EPVA believes strongly that Section 190 should be renewed by the passage of S.887.

We sincerely thank the Senate Committee on Finance for this opportunity to provide written comments.

PARALYZED VETERANS
OF AMERICA
Chartered by the Congress
of the United States

STATEMENT

FOR THE RECORD

OF

R. JACK POWELL, EXECUTIVE DIRECTOR

PARALYZED VETERANS OF AMERICA

TO THE

SENATE COMMITTEE ON FINANCE

CONCERNING

THE PRESIDENT'S TAX PROPOSAL FOR FAIRNESS, GROWTH & SIMPLICITY

AND

S. 887, WHICH PROVIDES FOR EXTENSION OF SECTION 190

OF THE INTERNAL REVENUE CODE OF 1954, AS AMENDED

OCTOBER 24, 1985

Mr. Chairman and Members of the Committee, on behalf of the members of Paralyzed Veterans of America, a congressionally chartered veterans' service organization, and all disabled and elderly Americans, I would like to thank you for conducting this examination of S. 887 which would extend, and not terminate, ways to improve accessibility by removing architectural barriers that confront handicapped and elderly persons in privately-owned, publicly-used places of commerce. I am R. Jack Powell, Executive Director of PVA.

801 Eighteenth Street, N.W., Washington, D.C. 20006 (202) USA-1300

My purpose is to provide PVA's concerns, interests, and justifications to seek the support of Congress to extend, and not terminate a valuable tax incentive in Section 190 of the Internal Revenue Code of 1954, as amended. PVA's position is in opposition to the "President's Tax Proposals to the Congress for Fairness, Growth and Simplicity," which includes a provision to terminate Section 190 when the present extension expires on December 31, 1985.

PVA and a wide variety of other disability rights organizations greatly appreciate the tax reform hearings conducted by this Committee, but remain concerned as no hearings are aimed in part at examining accessibility for the handicapped and elderly. Therefore, we are very pleased to comment for the record on S. 887, introduced by Senator Bob Dole, a legislative proposal which would extend the provisions of Section 190 for three years and create a reporting requirement whereby the efficacy of the Section can be evaluated.

Section 190 provides a $35,000 tax deduction for private businesses which have incurred expenses in connection with the removal of architectural barriers that confront handicapped and elderly persons. In 1983, the Joint Committee on Taxation previously provided an estimate that costs would vary from $7 million to $40 million, depending upon the maximum allowable deduction that Congress should authorize. PVA believes that the current $35,000 deduction would mean a minimal revenue loss of approximately $10 million annually to the government.

More importantly, the income tax incentive constitutes a creative and cost-effective way for businesses and the federal government to work together for the voluntary removal of architectural barriers that prevent the elderly, and over 36 million disabled persons, as consumers, and potential employees, from gaining access to places of commerce, housing, recreation, and employment.

It cannot be overemphasized that Section 190 is the only tax provision that provides both access and a meaningful private sector initiative that offers a purposeful return on investment.

The purchasing power of the disabled population has been inadvertently overlooked by the government and business by not providing reasonable access to disabled and elderly people. It is imperative that businesses recognize the value of the potential patronage of elderly and disabled persons. Renovation of a business establishment is a one time expense that consequently results in increased reasonable accommodation, patronage, sales, and tangible income that is enjoyed for the lifetime of that business. Once the access is provided, particularly in the small business sector, which is larger than the corporate structure, the immense potential for employment of disabled persons is increased.

The positive aspects of employment opportunities for the disabled have many health related and other personal ramifications, but what also may be overlooked by the government is that all sorts of good things happen when disabled persons achieve employment status. First, they become state and federal tax-paying citizens. As this occurs, we must be mindful that this in turn reduces the payment of support maintenance, programs and services

rendered by state and federal Human Services Programs for disabled individuals. It becomes evident that the reduction in services produces a reduction in federal and state budget outlays. Let it not be forgotten, that as disabled persons become employed, they will also be paying into the Social Security program in lieu of receiving Social Security benefits.

Everyone benefits - now, the disabled person enjoys new-found purchasing power, and joining the mainstream of society, the disabled person discovers a new brand of self-esteem. He or she serves as an example to family, friends and the community as a participating member of society. Yes, a simple tax deduction as provided in Section 190 offers endless benefits to all! Those businesses who have provided access to disabled people have, in effect, offered something of value to all people - they should be congratulated!

Senator Robert Dole introduced S. 887 (13 cosponsors). This measure provides a three-year extension of the $35,000 per year tax deduction and requires the Department of the Treasury to report to Congress the monitary amount and the number of taxpayers using the deduction. U.S. Representative Bill Boner (TN) introduced a similar measure, H.R. 1458, (62 cosponsors). There is one difference - H.R. 1458 provides for a six-year extension of Section 190.

Accessibility for elderly and handicapped persons in public buildings and privately-owned places of commerce, recreation, housing, and employment has long been one of PVA's highest priorities. Consequently, we have dedicated considerable effort to examining ways to improve for the handicapped this basic right of ingress and egress in public places.

In 1959, through the pursuits of PVA and at the request of the President's Committee on the Employment of the Handicapped, PVA became a committee member of the American National Standards Institute, Inc., and remains an active member today. The purpose of the committee has been accomplished - development of the "American National Standard Specifications for Making Buildings and Facilities Accessible to, and Usable by, the Physically Handicapped," ANSI A117.1-1980, as amended. The standard was ultimately recommended for adoption and endorsement by administrative authorities active in the construction, rehabilitation, and alterations of buildings, and facilities and site development so that those individuals with physical impairments can pursue their interests and aspirations, develop their talents, and exercise their skills when and where there is building accessibility.

Subsequently, the ANSI standards evolved into the Congressional passage of the "Architectural Barriers Act of 1968." PVA, highly involved in its passage, supported what became Public Law 90-480, August 12, 1968. It insures accessibility for the disabled in all public buildings financed with federal funds. Activities of PVA, continuing as an advocate for access, is reflected in our involvement in the efforts of the United States Architectural and Transportation Barriers Compliance Board (ATBCB) to develop and provide, as required by law, "The Minimum Federal Guidelines and Requirements for Accessible Design (January 6, 1981)." The introduction to the guidelines says, "The Physically Handicapped are citizens of this country - just as others of us are; they pay taxes and contribute to the economy of the country - just as others of us do; they deserve access to their public buildings on an equal basis with the rest of us."

The problem remains that access is not being provided in privately-owned, publicly used facilities. Extension of Section 190 will assist in alleviating this problem. It is for these reasons that PVA has endorsed the incentives created by Section 190 of the Internal Revenue Code to open publicly used places to the handicapped. Section 190 has consumed considerable efforts on the part of PVA in two ways: first, we have worked to make this expiring section of the Code known to business persons. Second, we have dedicated great effort in maintaining Congressional authorization as part of the Tax Code.

Quite briefly, Section 190, which was created in 1976, allowed businesses to make their facilities accessible and to elect to deduct accessibility-related costs of renovation from taxable income. It was anticipated, therefore, that whenever publicly-used facilities were routinely renovated, those having the work done would make the changes necessary to accommodate the handicapped. This effort has been hampered by the historic short-term authorizations of Section 190 which have not provided businesses adequate lead time to respond, upon learning of the existence of the tax deduction.

Tax laws combine with other social forces to affect the handicapped opportunities, and this fact is revealed quite clearly in housing. Consider an apartment complex where the owners desire to renovate it. The owners of that expensive venture reflect on alternatives as ways of making their apartments more attractive to the general population. Their goal is to make their apartments appealing to more potential tenants, or to those capable of paying higher rents.

To the able-bodied renter, waste disposals, balconies, and improved landscaping are more likely to come to mind as being more desirable than are ramps, bathroom grab bars, and widened doorways. It is easy to see, then, what the apartment building owners will do to upgrade their facility and to thereby appeal to the greatest number of people. It is also easy to see which group must search longer to find suitable housing.

Employment of the handicapped, like accessible housing, is an area of utmost concern to PVA. Perhaps the relationship between an income tax deduction such as that which exists under Section 190 and employment of the handicapped can be illustrated by developments in the electronics industry. It is worth stating at this point that electronics manufacturers have made considerable strides in hiring the handicapped, and the industry should be acknowledged for its accomplishments.

In the case of an electronics manufacturer who desires to hire handicapped workers, the income tax deduction can have special value. For example, the potential employer first must make his facility accessible for ingress and egress; therefore, he would add close-in parking areas and ramps and would make rest rooms accessible. Then, he would make the work site accessible, which would include modifying workbenches or obtaining special drafting tables.

Items used in these industries are quite expensive, and the specialized ones required by some handicapped employees are even more costly. However, once these basic alterations are made and the items are purchased, the qualified handicapped person is ready to become a skilled employee.

An industrial rehabilitation counseling service from Forest Park, Illinois, which specializes in promoting the employment of industrially-injured individuals, wrote to PVA, stating that the income tax deduction has helped open many employment opportunities for its clients that otherwise would not have been available.

Places of recreation and commerce also have been opened to the handicapped and elderly through the existence of the income tax deduction that is available under Section 190. For example, in Boca Raton, Florida, a town of 60,000 people, the Mayor's Committee for Disabled Persons, in mid-1982, undertook making stores accessible to handicapped persons. Even though state law requires that any public building constructed after October 1975, is to be accessible, there of course remain many facilities that are exempt. This situation is typical in most communities throughout the country.

The Boca Raton Mayor's Committee and the local Chamber of Commerce publicized the tax deduction available under Section 190. Then, they and local merchants worked together harmoniously to make two shopping centers accessible to the handicapped.

A member of the Mayor's Committee informed PVA that Section 190 was instrumental in this effort in two ways. First, businesses utilized the income tax deduction. Second, it was effective in a hidden way: the income tax deduction was an effective inducement which led many of these businesses to make their facilities accessible. Later, upon completion of the projects, business persons learned that modifications had entailed far less expense than was anticipated.

In Suffolk County, New York, a similar project (aimed specifically at adding handicapped parking, needed ramps, and curb cuts) was successfully undertaken in late 1982 by the County Office of Handicapped Services, a group of disabled veterans, and local merchants. The result was that over 200 handicapped parking spaces were installed, along with appropriate curb cuts and/or ramps. These ramps also are beneficial to the elderly and other shoppers with carts.

The Director of this County Office wrote to PVA, stating that the available income tax deduction helped them exceed the accessibility standards set by local law: "Many owners of shopping facilities took advantage of this federal tax incentive to add ramps and curb cuts at their shopping facilities which were not required by law...Business persons were willing to cooperate in this project because part of the cost would be offset by the federal tax deduction."

In Nassau County, New York, successful projects were also conducted. The Director of Services for the Physically Handicapped laments in one letter the expiration of Section 190 because, in its absence, there is "little or no 'business' leverage for local government offices like ours to create partnerships with the private sector in reducing these architectural and other barriers."

Senator Dole has incorporated into S. 887 a provision for reporting by the Department of the Treasury to Congress on the usage of the tax deduction. PVA believes Senator Dole is correct, and that this is an important aspect of the bill because so little information presently exists. However, the

existing information that is available stresses and points out the potential value and use of the tax deduction. Previous efforts regarding the effectiveness of Section 190, accessibility costs, and employment of the handicapped contend that the above is factual. The following three references point out certain facts by virtue of their differing, but related activities.

The Department of Labor, "A Study of Accommodations Provided to Handicapped Employees by Federal Contractors," June, 1982.

The Small Business Administration and Wright State University, combined their efforts to study the "Regulation and Small Business Participation in the Federal Contract Market," June, 1982.

An informative article Scientific American "Physical Disability and Public Policy," June, 1983.

PVA has observed several points regarding accessibility, based on limited responses by businesses. First, the vast majority of businesses did not know of the existence of the income tax deduction available under Section 190 of the Revenue Code.

Second, smaller businesses that are concerned enough to modify existing facilities in order to make them accessible to the handicapped are also likely to employ disabled people.

Third, most businesses that have made expenditures expressly to enhance accessibility for the handicapped and elderly have incurred expenses of less than $30,000.

Fourth, most smaller businesses that have inaccessible facilities and which do not intend to make them accessible cited expense as the reason for their inaction. Generally, these estimated costs exceeded $40,000.

Fifth, most larger businesses that have inaccessible facilities and which do not intend to make them accessible cited the large number of facilities as the reason for their inaction.

Sixth, both larger businesses and smaller ones that have more modern facilities do not require the deduction because their facilities are built to be accessible when constructed.

Based on these observations, it is apparent that smaller businesses will continue to be the primary users of any available income tax deduction aimed at removing architectural barriers. Furthermore, it is evident that those small businesses which have used or will utilize the deduction for the removal of architectural barriers are the ones that would expand and provide employment opportunities to handicapped workers. Accessibility is the key to employment; therefore, it becomes indicative that the income tax deduction could increase the number of employers of the handicapped and can diversify the types of employment available to the handicapped.

In June 1982, the Department of Labor presented a two-volume study entitled "A Study of Accommodations Provided to Handicapped Employees by Federal Contractors." Volume I contains study findings, and Volume II contains ten case studies. This study was prepared by surveying 2,000 federal contractors.

Few reliable studies exist that examine the cost of accessibility in the numerous places PVA aims for Section 190 to be effective, the diverse places of commerce, recreation, housing, and employment that are found in all cities and towns throughout the nation. Therefore, this study of government contractors is, perhaps, the most reliable information that is available.

However, this study of government contractors deals, quite naturally, with larger employers and does not examine what is required in making the smaller facilities operated by sole proprietors and par..erships accessible. Furthermore, the employers studied in this examination have had considerable economic encouragement to make their facilities accessible to the handicapped, since hiring the handicapped is, in many cases, a prerequisite for receiving government contracts.

It should be recognized that the small business entrepreneur does only very limited (or no) business with the federal government and has virtually no incentive or requirement to make its places of operation accessible to the handicapped.

The Small Business Administration and Wright State University, in 1982, studied the effects of regulations on small business and federal contractors'

compliance with Section 503 of the Rehabilitation Act. This study, "Regulation and Small Business Participation in the Federal Contract Market: The Effect of Section 503," is a detailed, 209-page report that was released in June 1982. Information for the report was gathered from questionnaires sent to 2,916 small business federal contractors, of which there were 726 usable responses. Like the DOL study, it addresses a wide variety of issues of concern to those who deal in the specialized field of government contracts.

The SBA study not only identifies the types of handicaps found in the work force, but it also attempts to ascertain the cost of accessibility among smaller contractors. This is a very difficult task, since only a small percentage have come within the requirements of Section 503. However, where there has been modification of facilities to make them accessible to the handicapped, "the mean cost per contractor is slightly more than $8000."

The June 1983, Scientific American (copy attached) contains a detailed study entitled "Physical Disability and Public Policy." This fact-filled article contains numerous statistics dealing with the incidence of disability, local governmental units' responses to the requirements placed upon them, and a discussion of the demands placed on our national systems of health and human services. It also contains suggested future actions our society and government must take, if they are to address the needs of the disabled.

The article concludes with a discussion of architectural barriers and the limitations they place on handicapped and disabled persons who seek to enter the work force. The article, at page 49, states:

> One of the most powerful tools of policy implementation is the variety of economic incentives that government offers through the tax system and through government expenditures. The economic-incentives approach to policy implementation has not been widely tried with respect to architectural barriers. Some states have introduced modest tax deductions for the removal of such barriers. Until recently the Federal income-tax code allowed businesses a modest tax deduction of $25,000 in any given year. The statutory authority for the Federal tax deduction, however, expired last year. Although the size of the Federal tax write-off was far too small to be noticed by most large businesses, such cost-sharing schemes can help to foster compliance with governmentally sponsored accessibility standards.

This article maintains that for many potential employers of the handicapped the cost of accessibility is prohibitively great.

It appears from PVA's experience that the income tax deduction has been more attractive to smaller businesses than to larger ones, which is predictable, considering the limited nature of the present maximum annual income tax deduction for $35,000.

As has been pointed out, the income tax deduction for accessibility-related expenses provided a useful tool for making publicly-used places accessible in cases where businesses operated out of facilities that were not originally built to be accessible. This deduction has been helpful in that it provided business persons an alternative to adding accessibility costs to the base value of their facilities and then depreciating those costs over a number of years.

Neither the government or PVA has been able to provide this Committee with precise statistics on the usage of Section 190 in the removal of architectural barriers. Senator Dole recognized this need to provide

Congress the necessary information to enable future authorization of Section 190. This is another reason to extend Section 190; otherwise the merits of the deduction will never be fully known. Senator Dole's bill, S. 887, offers the necessity of providing concrete statistics showing the effectiveness of Section 190 which is to be reported by the Department of the Treasury to the Congress.

In 1983, the Joint Committee on Taxation made the following revenue estimates for the extension and modification of Section 190:

| Option Under Consideration | Fiscal Years--Millions of Dollars | | | | |
|---|---|---|---|---|---|
| | 1983 | 1984 | 1985 | 1986 | 1987 |
| Make permanent Section 190 | - 7 | -13 | -13 | -12 | -11 |
| Make permanent Section 190 and increase limit to $50,000 | -13 | -25 | -23 | -22 | -22 |
| Make permanent Section 190 and increase to $100,000 | -40 | -39 | -38 | -37 | -37 |

As stated earlier, we believe the $35,000 deduction using the above estimates will amount to an approximate $10 million annually. We also believe these two-year old figures are still valid for reauthorization of Section 190. This projection, we feel, is minimal for a program that can be developed through private sector initiatives with businesses working together with the government.

We do question, however, if these estimates include factoring in the amount of revenues that would be generated by expanded employment of the handicapped. Furthermore, it is not clear that this projection considered

the savings that would result to the government when handicapped persons found employment and were no longer beneficiaries of federal programs.

Based upon the small revenue losses discussed above, and considering the important role Section 190 has played in improving accessibility for the handicapped and elderly in a number of communities, PVA feels very strongly that Section 190 should be extended. Importantly, PVA recognizes that if Section 190 is extended, provisions should be authorized for a significant period of time, and no less than the three-year extension offered in S. 887 by Senator Dole. In the past, short term renewals have largely defeated the purpose of Section 190, because it did not allow businesses sufficient time in which to plan renovating that would enhance accessibility.

We have very good reason for asking that Section 190 be authorized for a significant length of time: over the years Congress was committed to addressing larger issues to give much consideration to maintaining the provisions of Section 190. Very obviously, the handicapped do not benefit when this, the only provision of the Tax Code aimed at removing architectural barriers, is allowed to expire.

Furthermore, disability rights organizations such as PVA are primarily the groups that have and will continue to publicize the incentive to members of the business community. We have found individual business persons to be receptive to the removal of barriers, with financial incentives, but we have also discovered that the existence of this deduction addresses a very specialized concern and it is only beginning to be publicized.

When Congress has provided inducements for the sudden resolution of problems, there have generally been sizable economic incentives. There is little doubt that the removal of architectural barriers could be treated similarly, should Congress suddenly create an income tax credit for the full amounts expended in the removal of architectural barriers. Even though PVA would be pleased to see Congress provide such a moving incentive, it does not appear to be economically feasible or likely to happen at this time.

Finally, we are pleased to inform you that through the various, most recent activities of PVA's chapters we were able to substantiate that businesses do have an interest in Section 190 by virtue of their having sought the pertinent information. An excellent example is a chapter of PVA located in New York, the Eastern Paralyzed Veterans Association; during this past year, EPVA has successfully marketed the availability of Section 190 to businesses. EPVA's efforts are reflected by publication of articles in nearly 40 trade journals nationwide. This year, this activity resulted in the receipt of over one thousand requests from businesses for data on the deduction. The information was sent to all of the businesses that contacted the EPVA chapter. It is evident that, with the appropriate publicity, businesses will indeed respond to and take advantage of the available Section 190.

We believe that this is a cost-effective method of improving accessibility for the handicapped and the elderly, because it is private business and not the government that actually pay for the renovated improvements. To repeat, this is a superb example of the private-sector working together, voluntarily, with the government to achieve a purposeful endeavor and return on investment.

Please find attached additional evidence of support for extension of the Section 190 IRS Code from the American Institute of Architecture and the Executive Council of the Governor's Committee on Employment of the Handicapped. Also, attached is a letter from the "Jobs Accommodation Network" (JAN) of the President's Committee on the Employment of the Handicapped. While conducting an already ongoing and unrelated study, employers were questioned and the responses reflect that the employers' knowledge and use of Section 190 was minimal. This study was requested by PVA in connection with a JAN ongoing project. Note, it is of concern that of 56 employers responding during a two week period, less than 20 had heard of the tax deduction. However, it is encouraging that of this number, one quarter had used the tax deduction.

Mr. Chairman and Members of the Committee, PVA appreciates the opportunity to submit this testimony for the record, and we also appreciate the attention that each of the committee members may provide to extend and not terminate Section 190 of the Internal Revenue Code to provide inducements to businesses to remove architectural barriers that impede access of the handicapped and elderly to places of commerce, recreation, housing, and employment. The provisions of Section 190, which expires December 31, 1985, constitute the only measure in the Revenue Code that provides this much-needed incentive.

Mr. Chairman and Members of the Committee, PVA appreciates the efforts made by each of you to improve the well-being of handicapped persons. We are especially grateful that the Committee has taken time to examine an issue that is of great importance to disabled and elderly persons. I feel confident that we share the same goals, to open society so that these persons

can be active, productive citizens. Equally important, we wish to take this opportunity to publicly state our appreciation and thanks to Senator Bob Dole and Representative Bill Boner for introducing S. 887 and H.R. 1458, respectively.

Mr. Chairman, I appreciate the consideration extended to PVA by the Committee and its staff. This concludes my statement, and I will be glad to answer any questions that I can.

MEMORANDUM

SUBJECT: Comments on selected provisions of the President's Tax Overhaul Proposals

TO: Senate Finance Committee, Committee on Finance

FROM: William L. H. Morgan, Jr.
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1. Chapter 2.03. Repeal Two - Earner Deduction: For many years families which included two wage earners filing a joint income tax return where subjected to higher income taxes than would have been paid if the two wage earners could file as single taxpayers. This was primarily due to our progressive income tax rates. The two-earner deduction, although in most cases does not fully eliminate the added tax burden on two wage earner families it does at least reduce such. Although the reduction in the number of tax brackets and the lowering of the highest tax bracket as proposed in the President's plan would cause less of an impact on many two earner families than does the current tax structure, in certain income brackets there would remain an additional tax liability on two wage earners in a family over two single individuals. Therefore, some deduction, credit or special tax bracket should remain to eliminate this penalty for being married and both spouses working.

2. Chapter 3.01. Include in Income a Limited Amount of Employer - Provided Health Insurance: With rising costs of health care and the increasing cost to society and the federal government for those individuals with little or no health insurance, I would think the last thing the federal government would want to do would be to tax and in effect discourage employer provided health insurance. The President contends that by taxing a floor or base amount as opposed to the originally proposed excess amount of premium, a maximum amount of tax is being established. However, it is obvious that under the now proposed program every employee with any form of employer provided health insurance will be taxed, as opposed to only those with extensive benefit plans (or high premiums). Although I oppose any taxation of employer provided health insurance at least the taxation of an excess premium would allow for a some minimum amount of coverage to be provided at no cost to employees.

3. Chapter 3.02: Repeal $5,000 Exclusion for Employer-Provided Death Benefits: I do not feel that this item of the law is a substantial revenue loser and due to its very nature can it be subject to much abuse, therefore I do not understand the proposal to eliminate this benefit. This benefit could be quite useful to the family of a deceased lower paid employee with little or not life insurance and the taxation of such could substantially reduce the value of this benefit. If it is the general concensus that this benefit should be taxed, possibly the tax could be phased in or apply only if gross income of the recipient exceeds a given level. Similar to the taxation of social security benefits and unemployment compensation.

4. Chapter 3.04: Establish a Uniform Nondiscrimination Rule. I have been very concerned over the general trend the past several years with the inclusion of nondiscrimination rules in every tax provision effecting employee benefits. I believe these provisions severally hurt small businesses. I have heard time and time again from the owners of small businesses that their hourly employees are not concerned with amounts put back for them in pension and profit-sharing plans or what non-cash benefits may be available to them, many of these individuals wish to maximize their take-home pay. Some may take steps to secure their futures through investments, IRAs, home ownership. Others may live day to day and at retirement, have social security as their only source of income. However, the employers generally have enough trouble getting many of these individuals to show up for work timely and regularly and cannot begin to advise them on their long-term investment and financial planning goals. Whereas, at the same time, management level personnel are concerned about their retirement and realize that their social security benefits will be only a small fraction of their current income. Additionally, small business owners must compete with mid and large size companies to recruit management personnel and are at a severe disadvantage when it comes to available non-cash fringe benefits.

A general nondiscrimination rule would be a detriment on productivity in that if an employer can't provide some incentive for an outstanding job by one or more employees, without giving something to all employees, why should any employee strive to excel. I dare say that this proposal has more elements of socialism than capitalism as its basis.

5. Chapter 3.05. Repeal Exclusion for Employee Awards: My comments regarding this proposal are the same as those for Chapter 3.04 above. I would also add that this item's effect on the governments' revenue must be de-minimus.

6. Chapter 3.08. Repeal Exclusion for Prizes and Awards: My comments regarding this proposal are similar to those for Chapter 3.04 and 3.05, with emphasis on the fact that there are now relatively few situations in which a prize or award would be nontaxable and in such circumstances the recipient is "worthy" of the full economic benefit of the award without taxation thereon. Again, such treatment shows that the federal government wishes to encourage acts of humanitarianism, goodwill and of a world impact. In fact, an excellent United Nations resolution may be that no participating country shall impose a tax of any sort on the value of an award such as the Nobel Peace Prize.

7. Chapter 3.09. Repeal Deduction of State and Local Taxes: I believe this provision discourages and makes it more difficult for state and local governments to take on and carry on many of the programs which the federal government is shifting to them or requiring them to implement. No matter how hard the administration has attempted to argue otherwise in its explanation of the proposal, it does amount to multiple taxing authorities, taxing the same income. In fact, this proposal poses several ironies.

A. The federal government is willing to allow a credit for taxes paid to a foreign government with spending programs totally unrelated and uncontrolled by U. S. citizens, yet is not willing to allow a credit or even a deduction for taxes paid to a political subdivision of the U. S. itself, the spending of such taxes over which it may exercise extensive control through its federal matching programs; and

B. The administration argues that the nondeductibility of state and local taxes is not double taxation, while the nondeductibility of corporate dividends is and, in fact, the administration originally wanted a 50% dividends paid deduction for corporations and has included a 10% dividends paid deduction in its proposals.

8. Chapter 3.11. Limit Deduction for Entertainment and Business Meal Expenses: I object to this provision primarily on the grounds that I believe an expenditure incurred for business purposes should be deductible. I also feel that this proposal would discriminate against small business, in that, small businesses do not have substantial advertising budgets and therefore often compete with their larger competition through personal contacts with customers and customers' personnel. Additionally, often times it is not the business (large or small) that encourages the entertainment expenditure, but the customer or the customer's personnel who requests, encourages, demands that he be entertained in exchange for an order. The nondeductibility of any such expenditure would not

discourage such activity, but merely increase the costs to the provider. Often times legitimate and honest business purposes are served in such settings and such should not be discouraged. Last, but not least, this provision could harm the restaurant and entertainment industry.

9. Chapter 3.12. Limit Deduction for Travel Expense: I believe as is often done in government, this proposal overcompensates for some perceived abuses. Part 1 of the proposal whereby a one year standard is established for temporary versus indefinite status, does provide an objective standard, yet in certain circumstances a taxpayer's situation may be that an 18 month stay is truly temporary. When comparing this standard to the foreign Income Exclusion Rules, it seems ironic to encourage longer stays overseas and discourage such within the states. As easy as an objective standard such as this would be to enforce, I believe a subjective standard allows the flexibility needed to be fair in this area. If an objective standard is necessary why not have a multiple part test whereby the time frame is included with such elements as where the taxpayer's family resides, does the taxpayer maintain two residences, where does the taxpayer file his tax return and vote, and other such elements.

With respect to parts 2 and 3 of this proposal regarding transportation by ship and seminars aboard ships, similar to part 1, these total disallowances amount to overzealousness on the part of the administration I believe adequate tests could be devised to allow a deduction for ship travel and/or seminars on ships where a business or education purpose could be shown to be the primary reason for such travel.

I believe part 4, whereby no deduction for travel as a form of education, would be a grave error. I believe that teachers and educators who get involved in their work bring so much more to the classrooms of America. I am sure those physical education teachers who visited the '84 Olympics in Los Angeles, history teachers who visit Normandy, or Pearl Harbor, art and music teachers who visit the museums and conservatories of France, Italy and Austria are all significantly better teachers for the experience and bring an enthusiasm and insight back to the classroom that can leave an everlasting impression on the students. With the current conditions of our American education system, I believe this type of commitment by teachers and possible rejuvenation of teachers should be encouraged by our tax system.

I believe the effect on teachers is the best example of travel for education purposes, yet this same benefit can be available to other professionals. In my own field some of the better continuing professional education seminars are

in New York, Washington, San Francisco, under the proposal attorneys such as myself, and those in Beaumont, Texas, Little Rock, Arkansas, Tulsa, Oklahoma and other communities could not avail themselves of these programs without incurring substantial nondeductible expenditures. If there are true abuses in this area then take logical steps to curb the abuses but don't just eliminate the whole area.

10. Chapter 6.02. Reduce Double Taxation of Corporate Earnings Distributed to Shareholders: I agree with those economist that contend there is no tax on corporations, but merely on customers and/or investors and therefore, I agree with this proposal. However, I find the argument for this proposal contrary to that for the nondeductiblity of state and local taxes.

11. Chapter 7.02. Repeal Investment Tax Credit: I oppose the repeal of the investment tax credit. I see this credit as a true incentive for businesses to invest in new equipment and it encourages capital formation. If there is a perceived abuse then limit the percentage of a taxpayer's tax to which it may be applied in any given year, but it should not be totally eliminated.

12. Chapter 7.07. Deny Rate Reduction Benefit Attributable to Excess Depreciation: I feel that this proposal is tantamount a unilateral change to the terms of a contract after it has been signed and in effect for several years. It is not fair, equitable nor simple.

13. Chapter 8.04. Repeal Reserve Method for Bad Debt Deductions: Although I am also opposed to the proposed limitations on the use of the cash method of accounting my major concern in this area lies in the repeal of the reserve method for bad debts. Paying income taxes on income not yet received is a severe enough penalty and a significant drain on a company's cash flow, but to also require a company to pay tax now on income that can statistically be shown will never be received is raising the tax rate on real income. This provision is diametrically opposed to the supposed overall intent of the President's proposals and should not be included.

14. Chapter 9.03. Revise Minimum Tax on Intangible Drilling Costs: Because intangible drilling costs include such expenditures as wages and salaries, employee benefits, payroll taxes, insurance, fuel, etc. and are not significantly different from advertising and marketing costs for other types of businesses, I see no reason to tax intangible drilling costs any different than advertising costs and therefore, I oppose a minimum tax applicable to such.

15. Chapter 10.06. Impose Current Taxation on Life Insurance Inside Build-Up: I realize that many companies have structured life insurance products as a form of investment. However, the taxation of such prior to a closed transaction is contrary to our system of taxation. Investments in stock, bonds, real estate and annuities are not taxed until proceeds are received. In fact, nontaxable investments are encouraged through IRA's, home ownership, municipal bonds and other investments, I question why life insurance should be singled out and taxed entirely differently from other types of investments.

16. Chapter 13.01. Limit Interest Deductions: Rightly or wrongly, for years the tax code has encouraged borrowing through the allowance of a deduction for interest expense. If it is now determined that such should be discouraged, then as opposed to a strict dollar limitation to which many people may not be able to adjust within the time frame provided (thereby again, the government has changed the terms of a contract offer it has signed), some sort of combined dollar test and percentage reduction in one's interest expense should be adopted. Thereby allowing those taxpayer's with large amounts of interest who cannot pay off the underlying note, to show that their interest expenses is reducing by a certain percentage each year and thereby still be allowed their full deduction. Additionally, this is not a deduction of the rich as mentioned by the Administration, for the rich do not need to borrow, it is a deduction of middle America.

17. Overall Comment: I think the admitted fact by the President that the income taxes of all groups of taxpayers will not change significantly shows that these proposals are not real change, but merely change for the sake of change. The tax laws will still be based on the same 1954 Code, so where is the simplification? As far as the elements of fairness and equality, those perceived notions can be argued for the current system as much as for the proposed, depending upon enforcement and publication of facts, out of context.

As opposed to the President's exercise in changing the rules for the sake of changing the rules why not let the tax laws alone for several years, the complications lie in the constant change. If any changes are necessary, make logical adjustments to limited abuse and encourage enforcement, then pass a moretorium on tax legislation for at least five years.

We do not need to waste our time and energies on these changes which result in no noticeable difference in revenue or the tax system overall, if anything we should be considering a tax increase to help reduce the budget deficit.